

# THE U.S. TAX CODE'S IMPACT ON REVENUE PROJECTIONS AND THE FEDERAL BUDGET

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## HEARING BEFORE THE COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES ONE HUNDRED EIGHTH CONGRESS SECOND SESSION

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HEARING HELD IN WASHINGTON, DC, JULY 22, 2004

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## **THE U.S. TAX CODE'S IMPACT ON REVENUE PROJECTIONS AND THE FEDERAL BUDGET**

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**THURSDAY, JULY 22, 2004**

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON THE BUDGET,  
*Washington, DC.*

The committee met, pursuant to call, at 10 a.m. in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Brown, Garrett, Barrett, Diaz-Balart, Spratt, Moore, Scott, Capps, Thompson, Baird, Cooper, and Emanuel.

Chairman NUSSLE. Good morning. Welcome, everybody, to today's Budget Committee hearing regarding the impact of our current Tax Code on Federal revenue projections and the Federal budget. We are very pleased to have back before us as our first witness the Congressional Budget Office Director Holtz-Eakin.

Dr. Holtz-Eakin, thank you again for being part of our Budget Committee hearing. Thank you and thank your staff for the good work that you do. We really do appreciate all of the good work throughout the year that the Congressional Budget Office does on our behalf. We appreciate that. We want to make sure your folks back at CBO know that as well.

I would also like to welcome our second panel witness Pam Olson who will be here, who is former Secretary of the Treasury for Tax Policy; Dr. Peter Merrill, who is the director of the National Economic Consulting Group at PriceWaterhouseCoopers; and William Gale, a senior fellow at the Brookings Institute.

I will begin today with a brief overview of why the many problems and complexities of our current Tax Code are of particular concern to the Budget Committee and why we think it is critical to begin the discussion now. The first is, I guess, simply that the budget process and the Tax Code are inextricably linked. We collect Federal taxes to pay for Federal spending. The way I describe it to constituents back home is it is a bill. We do a lot of things out here in the Federal Government, and we present a bill to people for those services. Spending drives the process typically, so we need to know if we are consistently spending more than we are taking in and, if so, to what extent we are spending beyond our means, as well as what are we taking in in revenue and taxes in order to meet those obligations, and if the Code, the Tax Code, and the revenue is producing the revenue we need in order to meet those obligations.

In short, receiving reliable revenue data is one of the most basic, essential parts of the budgeting process. So for this committee to put together a reasonable budget, it is critical that the Tax Code allow for reasonable estimates of revenue.

What we have heard consistently over the years is just that statement: It is critical that the Tax Code allow for reasonable estimates of revenue. We get very frustrated, and I will be the first to admit that I am one of them who gets frustrated, with our analysts for the projections. But if they have an underperforming, or a nonperforming, or a very difficult to gauge any performance when it comes to a Tax Code, we are actually blaming the wrong—we are blaming the messenger and shooting the messenger as opposed to looking at the root cause.

In all fairness, estimating revenue is notoriously difficult for many reasons, but it is made even more difficult with all the wrinkles and complexities that the Congresses have added over the decades. And I know Mr. Scott will want to mention that as well. And I would certainly be interested, as he would, in how many of those pages have been added since Republicans took control, Democrats took control. We could have a good conversation about that.

The fact of the matter is over on that table is not even the whole story. We couldn't get the whole story here of what you need to know if you really want to be in complete compliance with the Tax Code. Just to give you an idea, there are stacks of 22 volumes that make up the IRS Code. That is the brown books, kind of in dead center over there, is the IRS Tax Code. Then you have 20 volumes of Treasury regulations that are supposed to fill in the gap, so to speak, because apparently 22 volumes are not enough to explain everything.

We wanted to bring in the judicial rulings of the Tax Code that are supposed to explain all the other stuff when taxpayers and the IRS actually disagree and go to court over it, but they fill up a whole wall at the Library of Congress. So we brought there a couple of volumes just to kind of identify them if you ever want to go over to the wall in the Library of Congress and look them up. We couldn't really find a truck big enough to get them all over here.

On top of that, there are thousands of pieces of what you call administrative guidance that are issued by the IRS, with more coming out probably on a daily basis. These are revenue rulings, revenue procedures, notices, announcements, private letter rulings, technical advice memoranda, but, of course, we did not have a hearing room big enough to hold all of those.

Suffice it to say it is very complicated. It is voluminous. And that is in part why we have a problem. It is this complexity and it is the level of fairness in transparency that makes this very difficult.

I will be the first to admit, Mr. Scott, and anybody else, that every time we talk about simplification, unfortunately we add pages. And getting to the root cause of that problem, whether it is Republicans or Democrats, is something we do have to come to grips with. We are not here to blame anybody, and I hope that we—certainly if that is what Members want to do. I think what we want to do today is learn about how to do a better job, whether it is Congress or forecasters or whoever it is, do a better job of getting

the information we need in order to make decisions. That is what today and today's hearing is about.

You have heard me complain about this before. I have heard other Members suggest that we talk about what we can do in Congress to get our arms around this so that we have better revenue data to make our decision.

Secondly, and probably more important, is the problems of the Tax Code are really not new, and it is pretty much always a reasonable time to talk about the problems, specific problems, within the Tax Code. So why is this important right now? Well, I think we have a window of opportunity that Mr. Spratt talks about all the time and other Members are quick to remind everybody about. There are several major factors that will be coming to a head over the next few years, including retirement of the baby boomers, expiring tax provisions, and, of course, the individual alternative minimum tax, or AMT.

As circumstances have dictated, we have almost taken on the whole—we have also taken on a whole host of large, relatively new demands on our budget over the past years, such as greatly increasing homeland security and defense spending, and, of course, we are also resolved to continue our commitment to long-standing domestic priorities, education, health care, environment, veterans benefits just to name, obviously, only a few.

None of these demands are going away right away or any time soon, and appropriately so. To add to all of this is the fact that we currently have a budget deficit, again not news to anyone, which has incurred in response to extraordinary sets of challenges, everything from obviously homeland security and national defense to economic downturn and, yes, purposefully reducing taxes in order to jump-start the economy, which has occurred finally.

To figure out how we are going to begin to address these problems, we need to have some sort of reasonable guide as to just what our revenue potential is. We need to know not just how to control spending, but by how much, just how big of a problem that is.

Again, I want to make it clear that the intent of this hearing is not to try and rewrite the Tax Code—even attempt to fix, for that matter, anything today—but to actually learn some of the problems.

Well, if you want to fix something today, Mike, we can do that. I am happy to entertain fixes, too. But part of the problem we have got is so many Members just assume that there is a Tax Code, we ought to have good data about it so we can make our decisions. What we consistently hear from our analysts is it is pretty difficult to make determinations about our Tax Code because of its complexities.

So there are great temptations to fix things piecemeal. We have tried to do that in the past. They really haven't worked. We have changed one part, and, however well-intentioned, it has had impact on other parts. It makes, obviously, the decisions of making the revenues and projecting revenues even more complicated.

Finally, I know we are in the season, I know there is ample opportunity for partisan bickering, and we can do that, but I really did want to have an opportunity to invite some experts in here to

learn what we can do from a more objective standpoint; not one particular tax cut or another or tax increase or another or tax provision or another, what can we truly do in order to make our revenue projections better regardless of what party is in control or what tax provision is being proposed.

So I don't want to waste this opportunity, and I do want to give Members the opportunity to learn today.

So with that, I turn it over to Mr. Spratt for any comments he would like to make. Then we will hear from Dr. Holtz-Eakin.

Mr. SPRATT. Thank you, Mr. Chairman and Dr. Holtz-Eakin. Thank you again for coming in. Thank you for your testimony this morning and the good work that CBO continually does.

Mr. Chairman, I want to applaud you for holding this hearing because I think it is useful, and timely, and probably overdue. We have several issues, as I see it, that we should be pursuing this morning. The first you have already touched upon, and that is how do we make revenue projections more predictable? How do we get timely estimates of revenues that we can expect in the near term in order to base our budgets upon them?

In this regard I think it is always a revelation to come on this committee or the Ways and Means Committee and find out how long it is before we have a handle on a break-out, breakdown of revenues coming in to the Internal Revenue Service, how much is capital gains, how much is payroll taxes, how much is income taxes, and to what extent are current revenues exceeding or lagging what we expected. Surely that ought to be something that all of the budget community in Washington is trying to do, and that is get a much, much better handle on timely revenue projections and break-outs.

Secondly, with respect to reliability, I don't think we should too quickly exonerate ourselves. When the Office of Management and Budget and the Congressional Budget Office both present us blue sky estimates that give rise to surplus projections of \$5.6 trillion, sometimes a credulous Congress is all too willing to buy into those blue sky estimates and to make big budget decisions based upon them.

We warned at the time that we shouldn't bet the budget on these forecasts, these blue sky forecasts, and we also pointed to some elements in the recent past that—upon which these forecasts were based. For example, for 8 straight years in the 1990s, tax revenues grew at a faster rate than taxable incomes. Everybody knows that can't go on forever. After 8 years it was about ready to peter out.

Secondly, there was a phenomenal increase in capital gains taxes in the 1990s. Capital gains taxes grew over a period of 5 years, 1995–2000, from about \$40 billion to about \$120 billion, and everyone knew that with the downturn in the stock market, that, too, was going to change. It was overdue when we got our estimates of the economy in 2001.

That is one thing we need to keep in mind, that we bought into it, and we need to be wary ourselves and learn from this experience about betting the budget big time on revenue estimates and economic projections that may not obtain.

Secondly, we are told now that the projected surplus of \$5.6 trillion was wrong by as much as 55 to 60 percent due to economic

factors and technical factors, and the larger of those two is technical factors. So the question we have to ask is are we refining our technical forecasting tools so that we don't make those mistakes again?

Third, we should always be asking, because we haven't spent nearly enough time on all the ad hoc tax measures that we are taking up here, doing what we did in 1985 and 1986, and that is cleaning out the closet. We have got an enormous amount of tax expenditures, tax credits, tax conditions, tax preferences that have built up in the Code over the last 20 years. It is about time, past time, we went back to the Code and clean the Code out, had a good closet cleaning.

In doing that we need to take care to do two things that most people don't understand are really sort of at opposite ends of each other. One is make the Code more equitable. The other is make it more simple and efficient. The two are not necessarily achieved in the same manner. They are awfully hard to do. But that question ought to be always before us, how do we make it more equitable, and how do we make it more efficient. Finally, as the books over there attest, how do we make it simple so that the average American doesn't get cynical about the Tax Code and say only the little guys pay taxes.

There is one thing that we should be wary of as we start taking up revenues; that is, about our expectations for the near term. We have been told that our revenues are below historical levels and our budget is in deficit partly because of the economy, but looking at CBO's analysis of a couple months ago, which indicated that the contribution of the economic cycle—economic cycle to our current revenue shortfall is really pretty small, it is about \$25 billion in fiscal year 2004 and is actually expected to be negative in fiscal year 2005; in other words, a problem right now in going forward with the—is not the economy, and the problem is likely to persist in the coming years. In terms used by CBO, revenues are down today and into the near-term future not because of economic factors, but because of technical factors. If I am wrong about that, I would appreciate you correcting me.

In other words, it is probably not a revenue pot at the end of the rainbow that is going to resolve our problems. We will have to do it ourselves with tough decisions. And revenues based upon a pick-up in the economy are not likely to bail out the budget problems that we have today.

That is a full plate to talk about today, and, Mr. Director, we look forward to your testimony. I appreciate your participation.

Chairman NUSSLE. Before we begin, let me also mention for our benefit that Tom Kahn is going to get married here August 1—he and his fiancee Suzy, we wish them all the very best. Now the date is set, and she is actually going through with it.

We welcome you, Director Holtz-Eakin. Thank you so much for spending your time with us today. Pleased to receive your testimony.

**STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR,  
CONGRESSIONAL BUDGET OFFICE**

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman and Mr. Spratt, members of the committee. We are pleased to have a chance to be here today. Let me add my congratulations as well, Tom. A man of your advanced age getting married is quite an accomplishment.

I really do want to thank the chairman and the ranking member for their very kind remarks about the CBO staff, who, in my opinion, do a simply incredible job with very little public recognition, and to get a little bit of that is nice. I appreciate it.

Before turning to my remarks, I would also like to encourage the chairman if he has to choose between blaming the messenger and shooting the messenger, we prefer blame.

My goal today is to talk about the challenges that the current Tax Code presents for budget projections, particularly at the CBO, but I think that in doing so, it is useful to the discussion in the larger context of economic policy, decision-making, and then budgetary presentation and think about where the possibilities of tax reform fit in that mix.

Stepping back, clearly the first and threshold decision being made by Congress is which programs to fund and at what scale, how much to spend on those different programs. That is the key economic policy decision that we discussed in testimony last year before this committee about the threshold costs presented in the Federal Government.

From a budgetary perspective, it would be useful to have a clear presentation of those commitments—to know what commitments have been made on the part of the Congress to command resources from the private sector and make sure that those commitments are presented in a clear and transparent fashion to allow policymakers to undertake trade-offs in looking at the relative costs of different programs.

We have worked with members of this committee for many years to look at some of the tougher and difficult issues in on- versus off-budget presentations and the presentation of economically equivalent, but apparently different, transactions—under, for example, the Credit Reform Act, which balanced the playing field between a direct loan and a loan guarantee—to make sure that the economically equivalent commitment of resources was reflected that way in the budget. And one could imagine even further discussions in that area on a wide variety of financial transactions or even such things as when a tax credit is really economically equivalent to a spending program on the part of Congress. Determining that would be a step forward in the presentation of that economic policy in a budgetary context.

Step 2 in that, of course, is to finance those programs at the lowest possible overall social cost, which includes costs of administration of the Tax Code, costs by taxpayers in complying with the Tax Code, costs in unfairness of the Tax Code from the perspective of policymakers, and, most fundamentally, interference of the Tax Code with economic decisions that lead to distortions that lower the overall efficiency of the economy and represent economic waste.

From that perspective it is useful to have a budgetary presentation that makes clear the kinds of resources that are being raised

in the Tax Code to finance spending programs and the likely receipts that will come with them, and also, where important to Congress, who really pays for those tax resources.

What is the state of affairs? We provided written testimony that focuses on three different pieces of the current Tax Code and the difficulties in budgetary presentation. The first is, looking forward over our budget window, the combination of sunsets, phase-ins, and then expiring provisions, and the difficulties that raises in budgetary projections; the second key aspect being the volatility of the tax base and decisions that have been made in the past and could be made in thinking about tax reform, about what would be in and not in the tax base; and then, finally, the differential taxation of economic activity across either different kinds of income or different kinds of activities, and also across individuals—which makes it more difficult to project the overall receipts that might come from the Tax Code as it is configured.

Let me begin with a discussion of the sunsets, the phase-ins, and the various expiring provisions. And a key issue here is what the private sector believe about the future of the Tax Code. If it is the case that member of the private sector firmly believes the Tax Code as written in current law with expirations, for example, of tax rates on dividends and capital gains in 2008, the entire sunset in 2011, then they will undertake to shift their economic activities, whether in real terms by actually doing things in different years, or at least in reporting terms by reporting transactions, realizing capital gains, and doing a variety of other things in response to that perception. And that will make it far more difficult to anticipate the likely receipts from the Tax Code.

On the other hand, it may be the case that the private sector doesn't believe that at face value. That raises a very difficult question in doing our budget baseline projections. The budget law is very clear that we should take and apply on the spending and tax side current law as it is written. However, it would be desirable to have that baseline dictum consistent with the underlying economic forecast.

One could imagine that the private sector believes that the Tax Code will evolve exactly as it is written, and, if so, we can construct an economic forecast based on that and then layer on top of it the current tax law to get the receipts that would likely come in. However, I think it is fair to say that is far from likely, that there are lots of at least pieces of the current sunsets and phase-ins and expiring provisions that the private sector doesn't believe will go as planned. If we try to put in the economic forecast that builds in the private sector's actual expectations, we will layer on top of it a budget law which is inconsistent with the underlying economic forecast.

And to make it worse, it is really impossible to say exactly what the private sector expects. So we are faced with a dilemma in simply constructing the baselines in the current environment. We have chosen to imagine that the tax law will evolve as it is written for economic as well as budgetary projections and are cognizant that that leads us to make mistakes in a very mechanical sense that will, looking back, appear to be unnecessary volatility. That kind of volatility, broadly speaking, is a cost. It is an uncertainty to pol-

icymakers about what is coming in and why, and it is uncertainty to the private sector in thinking about what will the Tax Code look like.

That is a situation that is probably not unique to the current environment. It is exacerbated by the variety of provisions at the moment. But general uncertainty about the Tax Code is something that the private sector has to deal with all the time, the prospect of change in the future. To the extent that the Tax Code was set in place and left alone for a while, revenue projections would probably improve, and private sector costs would be lower as well. I think that is an important consideration in terms of thinking about this topic.

On the volatility of the tax base, the CBO is painfully aware of how volatile things can be. For example, in 2001 capital gains receipts were \$100 billion. By 2002, they had fallen to \$57 billion. The inclusion of capital gains in the tax base as a result delivers some uncertainty into the revenue projections.

Capital gains are a piece that has gotten particular attention, but there are many other aspects that are imbedded in the technicals, as you mentioned, which are difficult to project with a lot of precision, and which raise the uncertainty about our technical forecasts.

Going forward, one could imagine lots of decisions made about the tax base for which different rates would be applied, and they would have different consequences for volatility. Some—a broad-based income tax would include capital gains, and that piece would contribute to volatility. Some would exclude capital gains. Some tax reforms might allow firms to entirely expense their investments in the first year. Investment is a notoriously volatile activity. We would have to deal with that in the revenue projections.

One can imagine some pieces—the compensation of employees through stock options and bonuses, which would be in any flavor of broad-based fundamental tax return—which would remain as a challenging projection issue for the CBO.

The volatility also figures into the final topic in our testimony, which the differential taxation across activities. At present, in rough terms, wage income is taxed in the aggregate at an effective rate of about 20 percent, whereas other compensation in the form of fringes at zero percent. Capital gains are taxed roughly at 15 percent. The return to investment in equipment is taxed at roughly half the rate, at the moment, as the return to investment in structures is. Those investments that take place in a C corporation are taxed at a rate that is probably about 10 percentage points higher than those investments that are done in the form of an S corporation. All of those features make it necessary to examine not just the level of taxation, but where the economic activity takes place in order to accurately project the receipts.

The same is true for individuals. Accordingly to data that is in the CBO's publication on effective tax rates, which we put out for many years, in 2001 the combined effective tax rate from the individual and corporation income tax in the bottom quintile, the lowest 20 percent, was -5.3 percent. Moving across quintiles to the top, it rises to .7, .45, 7.9, and 19.2 percent. So not only is it important to forecast the level of economic activity and the income that

it generates, it is becoming increasingly important in the baseline to forecast who gets the income and the effective rate at which they will be taxed. This raises the challenge for CBO in providing accurate revenue forecasts.

Going forward, there are two important transition issues that will be associated with thinking about fundamental tax reform. The first, and certainly the most important, will be the transition in the private sector and the impact on the economy of the adjustment costs in moving to a new tax system, and measuring the benefits of a new tax system net of those adjustment costs is a fair way to think about it. The same would be true in budgetary presentation: that, moving forward, there could be tremendous gains over time in the stability of the bases and the ability to project revenues accurately, but during the transition it is unlikely that the CBO or other entities interested in forecasting revenues would be able to do so with any great precision when we move from one Tax Code to another.

The focus, I think, on the whole, however, should be on the private sector. It is the case that to the extent that there is volatility in tax receipts and that volatility is not symptomatic of a fundamental imbalance, the U.S. Government has access to credit markets unparalleled in the globe and can smooth that volatility at a very low cost. Picking the basic level of spending, picking the basic level of taxes to finance that spending, and deciding upon the structure of those taxes to meet the overall goals of efficiency and equity are really core issues, and the volatility around that, I think, is manageable from both a budgetary and economic perspective.

That was the short version of the remarks that we submitted. We would be happy to elaborate to answer any questions you might have.

[The prepared statement of Mr. Holtz-Eakin follows:]

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, Congressman Spratt, and members of the committee, I am grateful for the opportunity to appear before you this morning to discuss comprehensive tax reform. I want to begin by emphasizing that my remarks focus on the Federal budget, with emphasis on the problems that the current tax system poses and that the reform of the system would pose for projecting revenues. These remarks do not extend to the merits or drawbacks of specific proposals.

From an economic perspective, the central role of the government is to provide services to the public that only it can provide (or provide adequately). Therefore, the threshold budgetary decisions faced by policymakers are about which services to provide and how much to spend on them. Those expenditures must be financed, and the challenge for tax policy is to provide adequate financing in a fair and efficient fashion. At present, the bulk of general tax revenues to the Federal Government derives from individual income taxes and corporate income taxes. In recent years, the combined contribution from those income taxes has been about 50 percent to 60 percent of Federal receipts, or about 8.5 percent to 12.5 percent of gross domestic product. Payroll taxes constitute another roughly one-third of receipts. But under current law, those taxes are linked to outlays for Social Security and Medicare. For that reason, I will ignore payroll taxes, although one could envision a comprehensive tax reform that encompassed them. The remaining sources of receipts are less than a tenth of Federal revenues. In light of the dominance of income taxes as a share of Federal receipts, discussions of tax reform are largely about reforming income taxes.

Its name notwithstanding, the underlying base of the U.S. income tax system departs significantly from definitions of income. Indeed, a chief difference among many

reform proposals is the question of the appropriate tax base. There are two useful benchmarks. One is a tax on comprehensive income (often referred to as a Haig-Simons income tax). Comprehensive income includes all labor compensation earned during the year (regardless of whether it is actually paid or deferred) and all capital income (again, regardless of whether it is realized or not). Comprehensive income measures the additions to an individual's potential to purchase consumption items. Actual purchases may fall short of that amount if he or she instead chooses to save part of the income, or purchases may exceed that amount if he or she spends out of past or expected future income.

The other benchmark is a consumption tax, or consumed income tax. It differs from a comprehensive income tax by excluding from the tax base that portion of income that is saved and by subjecting to taxation an individual's purchases. Because comprehensive income and consumed income differ only as a result of individuals' saving and investment decisions, it is possible to implement a consumed income tax by two means: by excluding saving from taxation or by excluding the income generated from saving and investment. Both variants have been proposed.

The current U.S. income tax system is a hybrid of those two benchmarks, albeit an incomplete one that excludes from taxation some items that would be taxed in either system. The current system relies principally on an income tax but embodies some elements of a consumption tax by excluding income saved for retirement and other uses. Some of the problems that arise with the tax system—both in terms of its effects on the economy and the difficulties it presents for budget projections—stem from that mixing of characteristics of income and consumption taxes. Many more difficulties derive from the ways in which the tax system departs from both concepts. For example, employer-provided health insurance, which is currently not taxed, would be taxed under either a pure consumption tax or a pure income tax, as would many of the expenditures that taxpayers are allowed to deduct in arriving at taxable income. Consequently, although some of the issues I discuss here might be addressed by the choice of income versus consumption as the tax base, many will arise in either case, because they are either unavoidable or the consequence of various policies that are independent of the choice of a base.

I will focus on four issues. The first three are general attributes of the current income tax system that impede reliable revenue projections: sunsets and expiring provisions, the volatility of income sources, and differential taxation. The fourth is transition effects—a consideration that must be taken into account in projections when any major change to the system occurs. Clearly, the most important consideration in evaluating the merits of a tax reform is its effects on the economy, and not the repercussions for Federal revenue projections. However, knowing the effects on projections illuminates the real costs to the economy because the two types of effects often stem from the same phenomena.

#### SUNSETS AND EXPIRING PROVISIONS

Under current law, the Tax Code contains a number of new provisions that take effect in phases and a number of expiring provisions. A few of the latter—notably the provision allowing partial expensing of equipment—were enacted to be temporary with a specific economic purpose in mind. The countercyclical effect of investment incentives such as partial expensing was enhanced by its temporary nature. Indeed, its future use as a tool to manage aggregate demand in the economy could be compromised by now extending it. But most of the expiring provisions were enacted as a step toward making them permanent or extending them indefinitely.

There are essentially two groups of expiring provisions. First, there are the roughly 30 so-called extenders: special provisions of the Code that have been extended a few years at a time and are regularly expected to be continued (see table 1). Most, if extended, would diminish revenues—altogether, by about \$175 billion over the Congressional Budget Office's (CBO's) 10-year projection period. Among the most significant of them is the credit for research and experimentation, which has been extended nine times since its enactment in 1981.

Second, there are the many provisions in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). They include all of EGTRRA's income and estate tax provisions, which are set to expire at the end of 2010, and JGTRRA's reduced dividend and capital gains tax rates, at the end of 2008. But they also include provisions such as the child tax credit, the expanded standard deduction, the 10 percent and the 15 percent brackets, and the increased exemption under the alternative minimum tax, which are scheduled to be reduced in 2005 (see table 2). While people hold diverse views on the future of those provisions, it is reasonable to expect that at least some will be extended.

Those scheduled changes in the Tax Code create a multitude of challenges for projecting receipts. In projecting baseline receipts, CBO is required to assume current law, a stricture that might normally coincide with “current policy.” However, at present, that requirement dictates that all of the legislated provisions are assumed to be phased in and to expire as scheduled in law, even though those required assumptions may differ greatly from expectations of current policy. Thus, even when CBO’s baseline projections are accurate, the presence of those expirations reduces transparency about just what to expect concerning the future course of the government’s fiscal condition.

An even more problematic feature of the gap between current law and expectations of policy is that budget estimates are based on the former and economic activity is influenced by the latter. In projecting revenues, one strategy for dealing with the problem is to assume that the public believes that all changes to the Tax Code will occur as scheduled. That approach has the virtue of being consistent with the baseline assumption of current law. Unfortunately, it has the drawback of divorcing the underlying assumptions about the economy from reality.

Assuming that the public expects the Tax Code to change as scheduled also complicates revenue projections. Expected changes in the Tax Code induce significant shifts in taxable economic activity from year to year. Some of that activity represents changes in behavior that lead to real changes in income, prices, interest rates, and other aspects of economic performance. Some is just reporting or accounting-shifting bonuses into the next or previous year, for example. Those shifts—real or reporting—lie at the heart of the desirability of tax reform; the fact that households and firms alter their behavior in response to taxes demonstrates the importance of tax policy. But such shifts in measured activity resulting from the scheduled changes in the Tax Code make projections more sensitive to policy than they would otherwise be—and do so unnecessarily if, indeed, the Code ultimately does not actually change.

Another way to deal with the problem of scheduled changes in the Tax Code in making projections is to assume that firms and individuals do not believe that tax provisions will change as scheduled but have their own view of how policy will evolve. That approach may make the underlying economic projections more realistic, but it renders them inconsistent with the rule that budget projections reflect a baseline under current law.

And here again the existence of scheduled changes in the Tax Code complicates projections. The approach makes it necessary to discern what the public expects and to factor in the effects of the public’s uncertainty. EGTRRA and JGTRRA contain many provisions that interact in a complicated manner, and predicting which provisions the public expects to lapse and which it expects to be made permanent is a complicated matter of judgment. Regardless of which approach is taken, baseline revenue projections are made less reliable by the existence of expirations that few people expect to occur as written in current law.

Those difficulties for revenue projections are reflections of the costs to the economy introduced by expiring provisions. When households and firms shift the timing of their economic activity for tax purposes instead of market fundamentals, the efficiency of economic performance is impaired. Advancing or delaying the recognition of income and expenses uses real resources. And although it may be worth it to a taxpayer to incur those costs in order to save on taxes, the resources used are lost to society with no offsetting gain. Similarly, the uncertainty caused by expiring provisions for revenue projections mirrors the uncertainty that they introduce into all economic affairs. That uncertainty imposes real costs in the economy as well, as resources are used to avoid it and as taxpayers’ choices are influenced by it.

And those costs from expiring provisions are not limited to explicit sunsets. Even without provisions that are scheduled to be phased in or to expire, frequent changes in the Tax Code inflict analogous costs. If EGTRRA were not scheduled to expire or if it had not been enacted, similar uncertainty about taxes could exist. The public has incentives to evaluate policymakers’ propensity to make changes to the Tax Code and to adjust its economic behavior accordingly. And the perception itself, even if nothing is actually changed, is enough to impose costs on the economy. Those costs can be reduced only by allowing the system some repose.

The propensity to change the tax system is reinforced in part by the many exceptions and preferences already built into it. Its mixed attributes of income tax and consumption tax bases and the many exceptions and preferences that cause the system to deviate from both concepts mean that there is no bright line dividing new provisions that would be consistent with the tax system and those at odds with its underpinnings. One special interest claim for preferential treatment may seem as legitimate as any other, making changing the Tax Code easier and leading to further instability in it.

#### THE VOLATILITY OF TAX BASES

Any comprehensive tax system will include some tax bases that are inherently more volatile than others. The current income tax embodies relatively stable sources of income such as regular wages and salaries, which yield relatively stable receipts. However, other sources of income swing more widely, which imparts volatility to receipts and makes projecting revenues more difficult. The current tax base, for example, includes capital gains, which are extremely volatile and unpredictable. Even though capital gains are taxed at substantially lower rates than most other income is, they nonetheless produce large swings in revenues. For example, as a consequence of a major adjustment in the stock market, receipts from gains realizations fell from \$100 billion in fiscal year 2001 to \$57 billion in fiscal year 2002. Because stock prices are impossible to forecast, the decline in gains was not foreseeable. And even after the stock market's behavior became evident, the impending change in receipts was highly uncertain because stock prices do not translate directly into gains realizations.

Capital gains are taxed under the current tax system because they are a form of income. However, under a comprehensive income tax, gains would be taxed as they accrued instead of upon realization. That change would not alter the fundamental difficulty of projecting fluctuations in the stock market, but it would eliminate the necessity of predicting taxpayers' decisions to realize capital gains. In contrast, neither variant of a consumed-income tax would tax gains; therefore, both presumably would avoid that source of volatility and unpredictability. For much the same reason, both variants of a consumed-income tax would tend to avoid the volatility that characterizes profits in general.

However, volatility is not necessarily more characteristic of one approach to tax reform than another. Instead, the details of implementation matter. While consumption is less volatile than income, most proposed tax systems retain some volatile sources in their tax bases. Those that exempt saving (sales and value-added-style taxes) include durable consumer goods in their base, for example, which imparts volatility. Proposals that exclude income from capital still have volatility from bonuses and stock options, which are one of the sources of volatility under the income tax. Moreover, under some consumption taxes, business income is taxed net of full expensing for capital outlays. Because aggregate investment can be more volatile than business profits, the business income tax base under such a tax can be at least as volatile as it is under an income tax.

In addition, volatility within a year may also be a consideration. Currently, most tax liabilities are paid as they accrue. Because wages are such a large part of income, withholding serves to match payments closely with the activity that generates them. Other forms of income should result in payments of estimated taxes through the year, but those liabilities can be harder to determine. Consequently, final settlements of liability are necessary at the time returns are filed. The current tax system results in "April surprises" that would not arise with some other tax systems, such as a wage tax or sales tax. Some consumption taxes, such as those for which the tax is collected at the point of sale, would reduce those surprises. Other consumption taxes, such as those that permit a deduction from income of contributions to qualified savings accounts, might be more difficult to pay as liabilities accrued, leading to potentially larger April surprises.

#### DIFFERENTIAL TAXATION

The existing Tax Code taxes different kinds of income at different effective tax rates (including, in many cases, a rate of zero). For example, in the aggregate, the effective tax rate on wage income (from the individual income tax) is about 20 percent. It would be lower if calculated on compensation, which includes untaxed fringe benefits. Yet capital gains income is taxed at about 15 percent. Corporate income tax rates also vary, with the return on investment in equipment now taxed at about half the effective rate of that on structures. The combined corporate and individual income taxes result in tax rates of about 25 percent to 30 percent on corporate income (which may be subject to both taxes), less than 20 percent on noncorporate business income (which is subject only to the individual income tax), and zero for the implicit income generated by owner-occupied housing (which is subject to neither).<sup>1</sup>

As a consequence of differences in effective tax rates, even an accurate forecast of overall income can yield an inaccurate projection of receipts if it is not allocated

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<sup>1</sup> Because the Tax Code is scheduled to change, those rates depend on which tax year is assumed.

correctly among various activities or individuals. The variation occurs across two dimensions. First, there are different tax rates depending on the different kinds of income and consumption. Compensation in the form of wages and salaries is subject to taxation, while fringe benefits, which serve the same purpose of compensating workers for their labor, are not taxed. Profits accruing to C corporations—but not those of proprietorships, partnerships, or S corporations—are subject to the corporate income tax. Capital gains are subject to lower rates and sometimes no taxation at all. Similarly, taxpayers' patterns of expenditures generate different effective tax rates. For instance, expenses for mortgage interest, charitable contributions, or state and local taxes reduce Federal tax receipts. As a result, projections of receipts depend on projections of the components of income and expenditures, each introducing yet another potential source of error in receipts projections.

The corresponding economic effect of that more complicated and less accurate budget projecting is the economic inefficiency associated with those differential tax rates. Firms and workers have incentives to tilt compensation toward untaxed fringe benefits. Capital flows toward lower-taxed sectors of the economy, forgoing higher gains to society that would accrue if invested elsewhere. Such incentives distort economic activity and lower overall efficiency. In addition, the preferences require higher rates to be applied to other forms of income, exacerbating the inevitable disincentives that income taxes cause for work effort. The effect is real and potentially substantial; incomes are lower than they would be without the distortions caused by the differential tax rates.

The second dimension is who earns the income. Some owners of capital—notably tax-exempt organizations—pay no taxes, so, overall, income from interest and dividends yields much lower revenues than profits and wages do. In addition, the progressive structure of the tax rates means that the effective tax rate depends on whether the income accrues to someone of higher or lower income. Consequently, to project receipts, it is necessary to estimate how much income accrues to tax-exempt entities and to forecast the income distribution among taxpayers.

Again, the budgetary challenge reflects an underlying challenge posed by the Tax Code. In addition to minimizing interference with economic decisions, exhibiting fairness is another metric by which a Tax Code is measured—often manifesting itself in the desire to tax higher levels of income at higher rates. However, as the desired progressivity of the Tax Code increases, a premium is placed on accurate projections of the distribution of income. For example, the share of taxable income taxed in the highest marginal rate bracket (39.6 percent) under the personal income tax rose from 12 percent in 1994 to 25 percent in 2000; so taxes were almost \$60 billion higher in 2000 than they would have been had the share taxed in each bracket remained constant (not including the effects of capital gains). While some forecasts may have anticipated an increasing concentration of incomes between those years, few would have anticipated such a large change.

#### TRANSITION EFFECTS

The previous three considerations point to how the current tax regime makes projecting receipts more difficult. My fourth point builds on the fact that all projection methods rely on history to a certain extent. And the current system has some track record. In contrast, any major reform involves major uncertainties about how the new tax system will function and how much it will yield. As a result, following the introduction of any significantly reformed system, revenue projections would probably become less reliable in the near term.

Again, the problems introduced for projections are reflections of factors at work in the real economy. The desirability of moving to a new Tax Code cannot be determined just by comparing what the world looks like now with what it would be like under a different code. The desirability of the reform also depends on the process of getting there. And the costs of the change could be significant. There are costs to reallocating resources to their best employment. In addition, some tax reform proposals, because of the effects they would have on prices, would create challenges for macroeconomic stabilization policy. Moreover, transition costs may generate perceptions of unfairness that lead reform proposals to incorporate relief to those most affected by the transition. But because such transition relief may mitigate the efficiency gains from reform, any tax reform proposal must be evaluated in light of the possible problems created by the transition from the old tax regime.

#### CONCLUSION

Budget planning is aided by accurate projections of receipts, but the current U.S. Tax Code has several features that make accurate projections difficult. Of course, ultimately the issue of tax reform is not about what the tax system or tax reform

does to analysts' ability to project revenues. It is about what taxes do to the economy. Nevertheless, some of the current challenges in making projections reflect the underlying costs imposed by the Tax Code.

Chairman NUSSLE. First let me ask unanimous consent that all Members be allowed 7 days to submit statements for the record at this point. I know there are a lot of Members that have an interest in this. So unless there is objection, so ordered.

Let me start, Director, by asking you to take the gloves off. Your three comments, your three main areas, obviously tax bases, where—how people generate their income and the volatility of that income, is not something that is managed very often here in Washington. It is just a fact of a changing economy. But the other two appear to be something that is determined here in Washington by one entity or another. So go ahead and take the gloves off as far as why these problems—sunsets, phase-ins, expiring provisions, differentiating tax, all of that is complication added here.

Let's go to Mr. Scott's point and others' point that we add this complication ourselves, whether it is Republicans, Democrats, Congress, President. Take the gloves off. Where does this complication come from, and how does—can you give an example of how something that seeming—maybe seemed innocuous at the time, but has, as a result, made it very difficult to forecast accurately the resulting revenue picture from a provision. If you have an example on your hit parade just to give Members an idea of what you are talking about, that would be helpful.

Mr. HOLTZ-EAKIN. I will give you a current events example which is drawn from today's New York Times, in which there is a discussion of Microsoft paying out \$32 billion in dividends. Those dividends, at least according to the article, are timed in part due to uncertainty about the future of the tax rates for dividends. And as a result, the decisionmakers at Microsoft thought they would pay it now as opposed to face anything in the future which might be a higher tax rate on dividends.

That is one tiny example of a calculation that is done myriad number of times in the private sector about financial transactions, about economic activity. And it would show up as receipts now that we wouldn't have gotten in our baseline because we didn't build in uncertainty about a new Tax Code next year. Our baseline said Tax Code on dividends will be the same until 2011.

So there you go. That is the kind of volatility that is out there underneath due to uncertainty about the future of the Tax Code. Some of that uncertainty at the present time, in your words, to take the gloves off, strictly driven by policy decisions about the Tax Code. We have lots of expiring provisions, lots of sunsets, some phase-ins.

The private sector is going to look at that and do its calculation about what is likely to evolve and make economic and financial decisions that are in its interest. We will have to figure out what that might be and guess what the receipts are.

It is actually in all three of the areas. To the extent that there are differential rates across time and differential rates across activities, say, dividends versus capital gains, there will be incentives to shift the composition of the tax base. There is always some underlying economic activity determining their composition, but if we

are shifting the composition of the tax base toward components that are more volatile, capital gains, because people can realize them when they choose to, instead of dividends which are paid out by the firms, that is a result of policy as well. So there are many features of policy that figure into this.

Chairman NUSSLE. Can you walk through the timing as well—and I am going to ask Secretary Olson this as well. Can you walk through the timing from—obviously we want to know what is coming in right now as an example. We want to know what the revenue picture is right now, or, for that matter, in order to make a budgetary decision for next year's budget as we are writing it, let's say.

When will we—so you are using projections. When will those projections become final reality, this is what actually did occur during that period of time, so that you can have a look back and see—what is the time frame? I have heard some people describe it as much as years, not days, weeks, or months. So could you describe the timing on that?

Mr. HOLTZ-EAKIN. One might like to think that in putting together our summer update, which will be out in a month or so, that we will be looking at complete 2003 data and projecting forward from that. That is not the case. We are building off of the—

Chairman NUSSLE. So we don't even have last year's data.

Mr. HOLTZ-EAKIN. No. We are building off data from 2001 as our fundamental detailed facts about the individual income tax, for example. So the first thing we have to do is project a couple of years of history and then build a 10-year budget projection on top of that. So timely access to comprehensive data is something that I think anyone in this business would argue would be very useful. It won't be a panacea, but it would be a very useful—

Chairman NUSSLE. But it is 3 years old.

Mr. HOLTZ-EAKIN. Yeah.

Chairman NUSSLE. So we are just now—I mean, most Members do not know that we are 3 years behind getting actual data for what occurred even—I mean, we are not getting today's data. We are getting data that occurred back in 2001 as final, close-the-books actuals of what is going on. And based on that you then begin to use that as a way to project what is going to happen in 2005 and beyond.

Mr. HOLTZ-EAKIN. More fairly, that is the access to detailed individual tax return data, so we know the distributions across people, for example. We do know more recent information on receipts that has come in the Treasury reports, daily Treasury statements, monthly Treasury statements. But those totals don't reveal some of the distributions that I tried to emphasize can be very important. For example, as firms send in their tax payments, we don't know the division between those tax payments which are for payroll taxes, Social Security, and off-budget items versus those which are income taxes.

When that money comes in, it is divided based on historical patterns, and we try to guess that division. But simply knowing that division would be extremely useful in distinguishing between those things that are meat and potatoes, wages and salaries, which give

you payroll taxes and other aspects of economic activity. So we are working with data which is incomplete in many ways.

Chairman NUSSLE. Is that data—I am sorry, my time has expired. I want to finish this line, and that is has the timeliness improved at all over your experience or your time of observing this; has it closed at all in, let's say, this 3-year lag, or is there any effort under way that you are aware of to try and close that gap?

Mr. HOLTZ-EAKIN. I am not aware of any effort. In the past 3 years, for example, it has been about the same system. I am not knowledgeable going back about what changes have been made.

Chairman NUSSLE. Mr. Spratt.

Mr. SPRATT. Thank you, Mr. Chairman. Going back to my opening statement, as you will recall, the CBO and OMB both projected a surplus between 2002 and 2011 of \$5.6 trillion. That was January, February of 2002. What is CBO's current estimate of how much that surplus, baseline surplus, has to be adjusted due to economic and technical divergences from what you expected due to economic and technical factors?

Mr. HOLTZ-EAKIN. Well, there are a variety of different answers. If you go back and look at what was projected for, say, 2004, in that period, in—say, in the year 2000 versus what we expect now, the difference breaks out roughly into 40 percent economic and technical and then 60 percent legislation divided evenly in the tax and spending side. That composition differs depending whether you do it over the 10-year window or whether you do it for a particular year in that window. But broadly speaking, think of it as a 50-50 divide as economic and technical and then other things—

Mr. SPRATT. Fifty to 55 percent over a 10-year period?

Mr. HOLTZ-EAKIN. As a rough—we can get you the numbers for every year. It differs depending on the horizon.

Mr. SPRATT. About 60 percent of that is technical misestimation, and 40 percent is economic misestimation.

Mr. HOLTZ-EAKIN. The 40 percent reflects a combination of economic and technical. That dividing line—to anyone who doesn't do this—is far from obvious. You might think of capital gains realizations as an economic phenomenon, but they fall in the technical category. The way the math is actually done is this: We look at our macroeconomic forecast for overall GDP and then at what wages and salaries, things like that. We explain as much as we can with that. The residual what is left falls into the technical category. And so there are many economic phenomena in there, shifts in the income distribution, capital gains.

Mr. SPRATT. To the extent that the economy doesn't grow as you expect it, you can assign that shortfall to economic factors.

Mr. HOLTZ-EAKIN. We do.

Mr. SPRATT. The remaining shortfall is assigned to a residual called technical factors, and you can't really sort out all of the technical reasons that you are not seeing revenues or spending perform as you projected.

Mr. HOLTZ-EAKIN. We go through each year, and, doing our baseline updates, we try to identify the different technical factors, but we can never exhaustively—

Mr. SPRATT. Do you make adjustments going forward for the technical factors then?

Mr. HOLTZ-EAKIN. Yes, we do.

Mr. SPRATT. As I recall—it has been a while since I looked at them closely—as you go forward in time, there is a convergence, a reconvergence so that the estimate of the economy tends to return to what it was originally. In other words, your technical and economic adjustments in the outyears tending to less than those in the near term. Is that clear?

Mr. HOLTZ-EAKIN. On the economy, it is fairly straightforward. We make an attempt to forecast the business cycle for 18 months, 2 years; beyond that make no attempt to forecast business cycles. It is beyond the capability of the science. We estimate the average performance over that period.

On the technical front, we review the technicals, and any new information that you get during the year you have to decide the degree to which what you have learned in the past year is actually informative about 10 years out. If you really believe there has been a fundamental change in the structure of the economy, then it would be appropriate to change the forecast 10 years out. If not, then you will phase it out over the 10-year window. It is a difficult part of doing the projections.

Mr. SPRATT. In the year 2011, according to your current projections, you are not making 55 percent in the original projection surplus for that year, I don't believe.

Mr. HOLTZ-EAKIN. OK. We can check that.

Mr. SPRATT. What you are assuming is that those misestimations become smaller and smaller over time. I guess the question I am asking is can we be sure that is the case?

Mr. HOLTZ-EAKIN. No. But I guess I would point to a different piece of evidence on that, which is that we also display in our projections the range of uncertainty surrounding them. It is clear that the fan chart of likely outcomes expands as you go forward just due to uncertainty about the how the economy and technicals will evolve. We don't move our point estimates for something 10 years away by an enormous amount based on a little bit of evidence in 1 year, but we do acknowledge the additional information and try—in the sense of providing good risk management skills to the Congress—to show the range of possible outcomes.

Mr. SPRATT. Let me ask you specifically with respect to revenues, you put out a publication in May called the "Cyclically Adjusted and Standardized Budget Measures," which was must reading for everybody.

Mr. HOLTZ-EAKIN. Pleased to hear that.

Mr. SPRATT. Table A(1) in particular shows that the shortfall of economic performance relative to the economy's capacity is about \$25 billion in revenues in the current fiscal year, 2004. But by 2005, next year, you show that the economic cycle will actually add revenues. So the economic factors' contribution to the deficit will have disappeared in the next fiscal year. All of it then becomes structural.

Mr. HOLTZ-EAKIN. That calculation is the answer to the following question: Suppose I could snap my fingers and make GDP and the economy move from its current level to the level that we estimate to be its potential, its capacity. If I just did that, I didn't change any of the technical factors, didn't change legislation, how much

more in receipts would come in? The answer is about \$25 billion based on our calculations.

Mr. SPRATT. One final question. Do you think that we should change the projecting rule by which you assume that tax cuts were built in, expiration dates, popular tax cuts with built-in sunset dates are soon to expire and not be renewed?

Mr. HOLTZ-EAKIN. The question, I think, is really what is most informative to Members. At least to my eye, the notion of extrapolating current laws is meant to capture what current policy dictates about the likely future fiscal outlook. When current law doesn't match a Member's view of the future, the future of current policy, I don't know quite how to resolve that.

Our approach has been to provide a variety of alternatives so that members of this committee and Congress in general can understand what the different likely outcomes are for different pieces of the budget where there is some uncertainty about how it will actually evolve. Having good information on the future is the key, I think, and making sure it is transparent and people can evaluate the path on which we are currently headed.

Mr. SPRATT. Thank you.

Chairman NUSSLE. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Mr. Director, under the current Tax Code, we see the books laying over there, and I know there has been a lot of effort in Congress to try to simplify the process. Have you seen any of the plans that are there that you think might be more workable than the system we have now, flat tax or some other scheme?

Mr. HOLTZ-EAKIN. We have looked—at the CBO and in my career prior to coming to CBO—at many of the prototypes for broad-based income taxes, for a flat tax which would be a consumption-style tax, value-added taxes. Each of those prototypes would involve a different set of trade-offs along the issues that I discussed in terms of what is in the tax base, volatility, the degree to which different activities are taxed at different rates.

But the common characteristics they have are that most prototypes have broad bases, and they have relatively low rates, so differential taxation is largely eliminated: Things in the base are taxed at the same rate. And they make a choice about the kind of tax base to which they aim.

Another characteristic they all share is they are all prototypes, and a comparison of the current tax system to a prototype model is not an apples-to-apples comparison. The real question is, what is a real live version of any of these tax reforms that we might see going forward? And that is an important question in thinking about how it would affect our ability to do the projections.

Mr. BROWN. Do you plan in your tenure to try to bring a recommended new plan?

Mr. HOLTZ-EAKIN. No. The CBO will not recommend a tax reform, but if Members would be interested in looking through the implications of any of those, we would be happy to work with you on that.

Mr. BROWN. Thank you.

Chairman NUSSLE. Mr. Moore. Oh, we will come back to Mr. Moore.

Mr. Scott.

Actually Mr. Moore was next. He is here. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman. Good morning. I appreciate you being here this morning.

What is the current deficit projected.

Mr. HOLTZ-EAKIN. Our current projection, published projection, for 2004 was \$477 billion. Based on what we know through this point in the year, we would expect it to come in below that. My guess would be for it to come in south of \$450 billion somewhere.

Mr. MOORE. How does that rank in terms of relative deficits we have had over the years in our Nation's history?

Mr. HOLTZ-EAKIN. In dollar terms it is large. Relative to GDP it is not the largest.

Mr. MOORE. In dollar terms is it about the highest we have had?

Mr. HOLTZ-EAKIN. Yeah.

Mr. MOORE. Does that include funding for Iraq?

Mr. HOLTZ-EAKIN. The 2004 numbers that we put together include the \$87 billion in appropriations for Iraq plus reconstruction in Iraq and Afghanistan.

Mr. MOORE. Have you heard there might be a request for additional or supplemental funding for Iraq?

Mr. HOLTZ-EAKIN. We are aware of requests and appropriations and/or authorizations for \$25 billion.

Mr. MOORE. That is not included in the \$450 billion you gave us, or is it?

Mr. HOLTZ-EAKIN. No.

Mr. MOORE. So that would put it up to \$475 [billion] again if that turned out to be correct?

Mr. HOLTZ-EAKIN. If it turned into outlays in 2004, it would be included in that number, but it would be highly unlikely that that sum could be spent that quickly.

Mr. MOORE. Is there a trust fund for Social Security?

Mr. HOLTZ-EAKIN. There is an accounting known as the trust fund, but there are no real economic resources sequestered in any meaningful way to pay those liabilities.

Mr. MOORE. You are aware of what lawyers are required to do in terms of keeping a trust fund, I take it?

Mr. HOLTZ-EAKIN. Yes.

Mr. MOORE. The trust fund for an attorney means a trust fund. If somebody violates that trust by taking money out of that fund, they can be prosecuted and/or disbarred; is that correct?

Mr. HOLTZ-EAKIN. That is my understanding.

Mr. MOORE. That doesn't happen in Congress, does it?

Mr. HOLTZ-EAKIN. That is also my understanding.

Mr. MOORE. So if we go into the Social Security trust fund and spend that money on tax cuts or other spending matters, that is just the way it is. Congress has the authorities to do that; is that correct?

Mr. HOLTZ-EAKIN. The unified budget allows resources to be spent on all kinds of demands.

Mr. MOORE. So that is a yes?

Mr. HOLTZ-EAKIN. I think so.

Mr. MOORE. How are tax cuts that we enact now paid for?

Mr. HOLTZ-EAKIN. In the end, all budgetary resources, spending, tax cuts are—the underlying source of all that is the U.S. economy. So independently of how you do the labeling, that is how we pay the bills in all public and private settings.

Mr. MOORE. OK. But Social Security funds then are used to pay for tax cuts now; is that correct?

Mr. HOLTZ-EAKIN. There is no one-for-one linking between tax cuts. We know that the net budgetary outcome at the moment is negative.

Mr. MOORE. You said there is not a separate Social Security fund technically except for under an accounting procedure; is that correct?

Mr. HOLTZ-EAKIN. That is correct.

Mr. MOORE. So right now technically money that is taken for Social Security is used to pay, along with other money, for tax cuts; is that correct?

Mr. HOLTZ-EAKIN. I don't think you can say that in the very mechanical way. The payroll taxes come into the budget along with other resources, spending goes out, the net effect is negative. Linking dollars coming in to dollars going out is not something that can be done in a deep economic sense.

Mr. MOORE. You are aware of the term PAYGO, correct?

Mr. HOLTZ-EAKIN. I am.

Mr. MOORE. Is that a budget enforcement rule?

Mr. HOLTZ-EAKIN. Yes.

Mr. MOORE. There was PAYGO in effect—what does PAYGO require?

Mr. HOLTZ-EAKIN. PAYGO requires that when Congress undertakes expansions of mandatory spending or cuts in taxes, that they be offset in the budgetary projections in a dollar-for-dollar fashion.

Mr. MOORE. That was the rule in effect until 2002; is that correct?

Mr. HOLTZ-EAKIN. Yeah.

Mr. MOORE. It expired at that time?

Mr. HOLTZ-EAKIN. Yes.

Mr. MOORE. You are aware of the new rule that requires PAYGO or pay-as-you-go for only spending, but not new tax cuts; is that correct.

Mr. HOLTZ-EAKIN. We don't actually have such a rule in place, but there have been obvious discussions in different parts of the Congress.

Mr. MOORE. That is what this Budget Committee is trying to do, at least the leadership?

Chairman NUSSLE. Does the gentleman have any questions about revenue projections he would like to ask? He can hold a press conference.

Mr. MOORE. I have 48 seconds, if I might, Mr. Chairman, please.

Chairman NUSSLE. You asked me a question, so I thought I would ask you a question back.

Mr. MOORE. I was just looking at you.

Chairman NUSSLE. And I was just looking back.

Mr. MOORE. Thank you, Mr. Chairman, with all respect. Would you agree with Chairman Greenspan that it might be advisable to enact the PAYGO rules we had up until 2002 when they expired?

Mr. HOLTZ-EAKIN. My own view is that if you look at the evidence, the key is not the rules, the key is what the policy objectives of the Congress are. And once a consensus is developed about those objectives, then rules can be put in place that will support that. But in the absence of a consensus about fiscal policy objectives, it is unlikely that rules will suffice.

Mr. MOORE. I am not sure I understand that, but thank you very much.

Chairman NUSSLE. Are there any other Members who would like to be recognized to ask questions about revenue projections?

Mr. Garrett.

Mr. GARRETT. I will not be looking at you. I will be looking over here.

Chairman NUSSLE. That is fine.

Mr. GARRETT. Thank you.

Before I begin, let me—in your written testimony you didn't use this language in your testimony here, but I just took note of it. You are talking about the Federal Government here, not the other governments. In your opening line the second paragraph is; "From an economic perspective the central role of the government is to provide services in public that only it can provide or provide adequately." That is from an economic perspective, obviously not from a real-life perspective, because we provide all sorts of services that the States could be providing and that business and communities could be providing as well, right?

Mr. HOLTZ-EAKIN. Yes.

Mr. GARRETT. Does that impact upon the rest of the testimony then?

Mr. HOLTZ-EAKIN. To the extent that the Federal Government chooses to undertake an activity, it has to be financed, and the commitment to spend those moneys raises the necessity of more receipts. You can solve that with either a broader base or higher rates. That figures into the kinds of feedback you get in the budget.

Mr. GARRETT. Mr. Spratt had an interesting comment. He said at the very beginning, which I think was right, that having a fairer Tax Code or simpler Tax Code may end up driving you in different directions. I mean, a fairer Tax Code might be a much more complicated Tax Code; is that correct?

Mr. HOLTZ-EAKIN. Certainly a core trade-off in tax policy is often presented as efficiency versus equity. That desire for higher tax rates on higher-resource individuals for the purposes of fairness leads to greater incentives for tax avoidance, shifting the way you do your economic transactions, or even evasion. The incentive would be to shift money from high-tax parents to their children, for example. That is the trade-off.

Mr. GARRETT. I am concerned about fairness for the people that I represent, specifically New Jersey, which is an affluent State, one of the most affluent States in the country, and has one of the worst rates of returns as far as on the other side, the expenditure side.

I just learned the other day that the average income for a two-income couple is around \$75,000–\$78,000 in the United States, but due to cost-of-living factors in a State such as New Jersey, that you would have to have around \$134,000 in order to have the same cost of living.

Assuming that is true, or ballpark figures, the individuals in that first category in the average number would be paying at a certain Federal tax rate, whereas the individuals that, presumably in New Jersey, would be at the higher tax rate, at the \$134,000, we would be paying a disparate amount of income tax, right?

Mr. HOLTZ-EAKIN. Mechanically, yeah.

Mr. GARRETT. So in order to alleviate that problem, it would be a more complex code, but would the fairer system be to have some sort of a cost-of-living index in the Federal Tax Code either on a regional basis or State basis or county basis or some other census figure basis to apply to those richer States so that we pay a fair amount and not pay more amount than any other States?

Mr. HOLTZ-EAKIN. You could imagine a system that attempted to adjust for real purchasing power in some way across geography or anything else, but you could also imagine the complications involved in what happens when people move, and a whole variety of other things that may make that unworkable in practice.

Mr. GARRETT. On the expenditure side of the equation, of course, a State like ours always gets the short end of the stick. I always used to say 50 out of 50, but when you include the District of Columbia, we are actually 51 out of 51 as far as the return on the dollar. So isn't that exacerbated by the fact that we are paying at a higher level and getting back at a much lower level then, without having some sort of factor in there?

Mr. HOLTZ-EAKIN. Well, in the same way that moneys come in in one form and go out in another, coming in from one State and going out to that State is really a policy call. What New Jersey gets in terms of outlays in the programs is something that is controllable by policy, and I think not really driven by configuration of the Tax Code.

Mr. GARRETT. But the first half of the equation is figured by Tax Code as far as us having a higher cost of living and necessarily being in a higher tax level because of that; that is, as far as the Tax Code.

Mr. HOLTZ-EAKIN. Be cognizant, however, if individuals are savvy, and I would stipulate that there are a lot of savvy individuals out there, they are going to recognize when they choose to live in New Jersey that that is a consideration. So overall, there might be an impact on bidding for house prices and prices might be lower otherwise because residents face this other burden. They might have chosen to live there and be just as happy living in the New Jersey.

Mr. GARRETT. Yes, but the cost of prices of houses in New Jersey?

Mr. HOLTZ-EAKIN. Actually I lived in New Jersey for 10 years. This is a fundamental conundrum in tax policy that will not be resolved here. Do you want to measure things on the basis of what comes in or comes out?

Mr. GARRETT. One last question. Your comment is if we leave the overall system alone, you have less as far as economic impact on the system and less cost to the system. You said complexity will add to the cost of the system, and changes to the system will—changes, incremental changes, will drive up the costs of the system.

So if we were to make any changes along the line, as Mr. Spratt's opening comment saying we should start clearing out the closet of these things, that would add costs to the system, whereas if we leave it alone, we will have a flat cost overall as far as intermediary cost to the system as far as changes are concerned.

Mr. HOLTZ-EAKIN. Well, the real issue is how often do you change.

Mr. GARRETT. Yes.

Mr. HOLTZ-EAKIN. If you change once, hold the system stable in a way that has lower compliance and economic efficiency costs, then that net benefit could very well be positive. If you change every year, you are imposing an uncertainty and economic cost on the private sector that you should certainly be cognizant of.

Mr. GARRETT. Thank you.

Chairman NUSSLE. Now, Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

You are familiar with this chart?

Mr. HOLTZ-EAKIN. I think I saw it in a previous visit to this committee.

Mr. SCOTT. You are going to be seeing it a lot. The curious thing about this, if we go to the next chart, is that according to the information we have been given, in February 2001 we thought this year's budget surplus would be \$268 billion. A year later, in February 2002, we thought it would be almost balanced, but a little bit in deficit, \$14 billion. Now, maybe September 11, could have done that.

But from February 2002 to February 2003, this year's budget looked like it was going to be \$300 billion in the hole. Now you are saying \$400 [billion], depending on what happens with the extra money for Iraq—\$450 [billion], or \$475 [billion].

What happened after February 2, that caused such a total collapse in the budget estimates, or do you disagree with these estimates?

Mr. HOLTZ-EAKIN. Well, these are all of these estimates, so I am not familiar with the details of them. The CBO estimates over the same period have a comparable profile, and as I have mentioned to Congressman Spratt, the difference between what one sees at the beginning, say, February 2001 and what the outlook might be today in 2004 is divided between economic and technical, typically something like 40 percent and then legislative initiatives on the interim, on both the spending and the tax side.

Mr. SCOTT. But I think it is clear, you can't blame September 11, on anything that happened after February of February 2002.

Let me ask you another question.

Mr. HOLTZ-EAKIN. It can—it is partly fractional and partly legislation differences on the year.

Mr. SCOTT. When you consider tax cuts, do you consider which taxes are cut in terms of how it will effect the economy?

Mr. HOLTZ-EAKIN. Yes. If one cuts marginal tax rates, that has some economic—beneficial economic feedbacks in the individual and aggregate level, if it is sufficiently large. If one cuts something that is not a marginal tax rate, it has a different impact in terms of inducement to spend more in consumption. We try to figure that into our economic—

Mr. SCOTT. But it could be better or worse.

Mr. HOLTZ-EAKIN. We would expect in a recession, for example, the impact of additional consumption is sometimes beneficial, that would provide support.

Mr. SCOTT. Did you consider the Joint Committee on Taxation analysis of the 2003 tax cut that showed there would be a short-term spike in jobs, but long term would be worse off as a direct result of the 2003 tax cut—would have fewer jobs as a direct result of bypassing the 2003 tax cut? You are not familiar with that analysis?

Mr. HOLTZ-EAKIN. We didn't adopt that in any way. I am sure the staff has looked at it. I personally have not, and we try to include the current tax laws in all our projections going forward at any point.

Mr. SCOTT. Could I have the next chart?

We have kind of gone over this a little bit. As I understand it, you are projecting a 16.9 percent of GDP as revenues for next year?

Mr. HOLTZ-EAKIN. Sounds about right.

Mr. SCOTT. Other than the previous 2 years, when is the last time we have had a 16.9 percent percentage of GDP in terms of receipts?

Mr. HOLTZ-EAKIN. I don't know the exact year, but the postwar average is a little above 18 percent, and this is below that.

Mr. SCOTT. Fifty years?

Mr. HOLTZ-EAKIN. Well—

Mr. SCOTT. You are projecting a good economy, too?

Mr. HOLTZ-EAKIN. In our most recent projections from March, we had a robust cyclical recovery in 2004 and 2005. And after that, we project sustained economic growth at something about 2.8 percent per year.

Mr. SCOTT. And so I guess you are calling that a good economy.

Mr. HOLTZ-EAKIN. We had a robust cyclical recovery in 2004, 2005. After that we project sustained economic growth at something about 2.8 percent per year.

Mr. SCOTT. So I guess you are calling that a good economy?

Mr. HOLTZ-EAKIN. 4.8 percent in 2004 and 4.2 percent in 2005 is a robust economic recovery.

Mr. SCOTT. You are only projecting a 16.9 percent GDP at a level that you haven't seen since 1959?

Mr. HOLTZ-EAKIN. I agree on your word. On the date we can check.

Mr. SCOTT. With these lowest receipts, we haven't done much on lowering outlays, is that true, in terms of GDP? I am looking at the graph. It is right in the middle, and the receipts are way under the line.

Mr. HOLTZ-EAKIN. Depending on how the outlays are constructed going forward, that depends on your definition of discretionary, which CBO increases by inflation. I am not sure if that was the question.

Mr. SCOTT. I think the graph speaks for itself. We have low income and high outgo, so that explains the first chart that we showed.

I don't have any further questions. Thank you, sir.

Chairman NUSSLE. Yes. If you could leave that chart up there, I think it says prepared by the Democratic staff, and we are not talking about revenue projected by the Democratic staff today. We are talking generally about how revenue is projected.

Mr. SCOTT. Well, do you disagree with the numbers? For the good of the bench.

Chairman NUSSLE. I was pointing that out for the good of the order.

Mr. SCOTT. We will make it his projection if he would answer the question.

Chairman NUSSLE. All I am suggesting, there are probably comments to be made on both sides, and we are not here to talk about revenue projections made by the Democratic staff.

Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman.

Mr. Director, thank you for coming here today. I will try to keep it on what the topic is today. I am from South Carolina, and we think things should be simple. I have only been in Washington a couple of years, and I guess I am not quite cynical enough to think that we can't do that.

Is it possible, Mr. Director, to have a paradigm shift? I mean, let us talk about policy, and let's talk about politics, and let us, you know—the political end is, when you talk to people in South Carolina, when you talk to people across the Nation, 80, 90, 95 percent of the people say, please make it simpler.

And I am talking about the tax cut, and I think that is a universal theme, and I think that is what we are talking about here today, something that we can make simple, something that we can have data accurately and quickly, rather than 3 years later.

You have got to tell us if there is a plan, or is it possible to have a plan? I have seen the plans. Is it possible to have a plan, a consumption plan or a flat tax plan, that can accomplish what we want to do?

I am not talking about the politics. Take the politics out of it. Is it possible to have a policy that we can have that can move this country forward, that can be simple, that people can sit down and figure out their taxes by themselves without having H&R Block come in and all of these other things—I mean, it is beyond my comprehension that we can't, whether it is a paradigm shift, whether we do it in stages or whatever. Enlighten me just a minute.

Mr. HOLTZ-EAKIN. From the perspective of the economics, certainly many of the broad-based income or consumption tax plans that have been proposed would be much simpler to understand. They would have beneficial economic effects in reducing economic inefficiencies. Whether they would be simpler to comply with, everyone suspects the answer is yes. But for a person who has life a W-2 that with his or her wages, salary and income and who does not have a very complicated financial life, probably not much would change, quite frankly.

And, you know, the real issue is how to move including the politics from the current system to that when in the deeper sense it is desirable public policy. But from a economics perspective, it is hard to imagine not seeing the potential for gains from a more efficient Tax Code.

Mr. BARRETT. Let us say we wave the magic wand and we went to a consumption tax. Do you think it would be possible to do a total shift within 1 year, or would it be something that would probably have to be phased in, Mr. Director?

Mr. HOLTZ-EAKIN. There are many different flavors of consumption taxes. You could go to an extreme where you did a national retail sales tax, where you taxed all consumption purchases at the individual level. That is a very big change in the administration, the compliance, the collection, and one would be hard pressed to imagine this happening quickly.

There are other flavors of consumption tax that could be administered in a fashion that is much closer to our two-part taxation of income at the individual and at the corporate levels. That kind of transition one could imagine occurring much more quickly. It really would depend on the way one went about doing that. Not all the consumption tax plans are the same in that respect.

Mr. BARRETT. The chairman made reference earlier if we brought all the regulation, litigation, all the paperwork that was required, it would probably fill up this room. I have seen so many estimates of the costs of implementing these regulations. Tell me your estimate, what CBO has said the cost of making sure that people comply with it, with the Tax Code, is.

Mr. HOLTZ-EAKIN. We don't have an estimate, to be honest. There are widely varying estimates that are in the literature. Quite frankly, the next panel is better equipped to answer that. We would be happy to look at it for you if you like.

Mr. BARRETT. Would a shift like that, if we could make it simpler, would it be easier for you to bring projections to us so we could make intelligent decisions or better decisions, I will say, on how we spend our money and what we spend it on?

Mr. HOLTZ-EAKIN. First, on the outlay side, how you make a decision of how you spend your money is how you present the alternative program. So that is an ongoing issue.

Mr. BARRETT. Sure.

Mr. HOLTZ-EAKIN. On the receipt side, it will depend on the transition where, quite frankly, it is likely we do worse. In the new world transition in the private sector, we are trying to guess and respond to how people reported, and then to the extent that the Tax Code settled down. And I think an important issue is why the Tax Code is complicated now; what are the incentives to make it complicated? Well, there are sometimes pay-offs to have taxes complicated, so it is desirable. But making it settle down would make our job easier. So there is a trade-off.

Mr. BARRETT. Thank you, Mr. Chairman.

Chairman NUSSLE. I thank the gentleman.

Mr. Baird.

Mr. BAIRD. I thank the chairman for holding this meeting.

Mr. Holtz-Eakin, we always appreciate your frank and informative conversation with us. I mean that sincerely. I share the chairman's astonishment at this issue which came up at the end of a hearing about a year ago.

When you get money, it is almost as if it is giant sacks, and you don't know how much should go to Social Security, how much to

Medicare, how much came in from corporate taxes. We have broad numbers, but no specifics; is that accurate?

Mr. HOLTZ-EAKIN. When income and payroll tax withholdings comes into the Treasury, the receipts are lumped together. In some cases companies do report voluntarily, but there is no requirement that the money come in labeled for the tax—in particular Social Security versus other—for which it is sent in. So we don't really know on an ongoing basis.

Mr. BAIRD. What puzzles me about this is when I calculate my taxes, I have got to sort out how much I owe in Social Security. A business does as well, if I have to calculate my quarterly estimates. Why is it that that is not tracked electronically or physically in some fashion?

Mr. HOLTZ-EAKIN. I actually do not know.

Mr. BAIRD. Mr. Chairman, I would hope and offer to work with you on this that we could really find a way with you. Maybe the Ways and Means Committee will get less excited about jurisdictional issues, but it is just common sense.

It seems to me if you were to tell the American people this, if you ran your own budget or business budget, you just wouldn't run your business or home that way. If we run our company or home that way, it is not surprising that you folks give us 3-year-old numbers and we see more dramatic shifts of \$40 [billion], \$50 [billion], sometimes \$60 billion a year.

You know, when you are doing your estimates, one of the things I am puzzled about, you hear statements about dynamic scoring of taxes. Do you ever dynamically explore expenses?

Mr. HOLTZ-EAKIN. We do not incorporate macroeconomic feedback into our cost estimates on the outlay side. We do, and I think it is a fair statement to say that the joint committee does, on the tax side look at individual-level behavior and the incentives that would be in an outlay bill for whoever might be affected to change their behavior. So it is not that our cost estimates are static in the sort of naive sense that you assume the world is fixed, but there are certain feedbacks that we do not explicitly incorporate, and they are largely macroeconomic.

Mr. BAIRD. OK. So for example, if you were to say what are the net long-term benefits from expenditures on education or expenditures on transportation, that is not allocated?

Mr. HOLTZ-EAKIN. We leave the future cost of GDP explicitly unchanged in doing estimates. So it is explicitly off the table.

Mr. BAIRD. OK. Following our discussion a year ago, someone explained to me that many corporations have separate earnings reports. In other words, they report one set of earnings for the purpose of taxation, and a separate set for their stockholders. Is that accurate, and how—does it make sense, and how does it affect your work?

Mr. HOLTZ-EAKIN. There are different financial reporting versus tax reporting. Our focus is on the tax side.

There are a few instances where we have tried to look at the financial reporting to bring extra information. Stock options, for example, stand out. In looking at the late 1990s and then the most recent couple of years, the large run-up in bonuses and options and then the drop-off in those kinds of things do affect receipts.

Supplementary information out of the financial reporting is something we have tried to get our hands on in order to better understand the future of the tax receipts. It is a challenge.

Mr. BAIRD. I raise that issue because it seems to be congruent of our discussion today of the complexities in the Tax Code to some extent and also with how we predict revenues.

I don't have any further questions.

I guess I would just, Mr. Chairman, appreciate it if we could work on this issue.

Chairman NUSSLE. Yes, and it may take—and we may want to talk to Ms. Olson, who is probably as versed in this as anyone, and someone I have spoken to about this before, as well as the Ways and Means Committee. My understanding is this May take a legislative fix or adjustment, in addition to the fact that we shouldn't be complicating the Code.

But so this is something that I am very happy to work on. You are right. It may have some extrajurisdictional complications, but, hey, you and I have done that before.

Mr. BAIRD. Mr. Chairman, I applaud you for that leadership.

Chairman NUSSLE. So we can add to that pile any time we want. You have nothing further then.

OK. Let us see, who is next on my list?

Mr. Emanuel.

Mr. EMANUEL. Thank you, Mr. Chairman, for holding the hearing.

There was a recent report, I think it was picked up by a number of—both the Wall Street Journal and New York Times. There is some \$311 billion, on a low estimate—I met with the IRS commissioner, he said that was a low estimate—underreported and not collected in tax returns, mainly high-end individuals that companies just don't—either hide money, don't file, don't return, don't pay. And the complexity, I mean, for all of us who struggled on dealing with the issue of a balanced budget, the complexity has led to a situation, in fact, where, in fact, what is owed to the government is not being paid.

There is some earned income tax credit earned. In terms of the complexity there leads, I think, to what we call—some would use the term fraud. I would not use the term fraud. It is the complexity to let people, A, not filing who do deserve it, and, B, those who file wrong because of the complexity, not intentionally, but that is the end result. But the \$311 billion would get us more than halfway toward eliminating the deficit, the annual Federal deficit.

Since 1994, we have added about 10,000 pages to the Code and made about 3,500 changes. So in the last 10 years you can think about 350 changes a year in the Code and added about—if my math works correctly—about 1,000 pages' worth of changes to the Code.

So when we hold that up as a symbol of the complexity, we are part and parcel—what happens is, as you know, about every 20 years we try to simplify it, and then we try to make social changes with it, adding the idea of a deduction for higher education or health care, et cetera, and try to achieve some policy changes that we don't do through government spending, which adds credit, then complexity, and we just go backwards.

I am open to the idea of tax reform, I have opened my own proposal about taking the earned income tax credit, the per child, dependent care, collapsed down to a single credit, have it down to 12 questions and eliminate well over 200 pages of the Code. But the truth is that simplicity costs money, and you can't do it on the cheap.

One of the questions I have here is, A, how do we do a better job of dealing with that \$311 billion that goes underreported or not paid and is hidden and using the Tax Code against the fairness that is expected in the tax system?

I will start there, and then I have a follow-up question.

Mr. HOLTZ-EAKIN. Well, I think the good news is that the tax policy community in general, the research community and practitioners all believe the U.S. Tax Code is the best in the world. The bad news is it relies heavily on voluntary compliance. And in the face of incentives to not comply or inability to comply, or reasons we just don't understand, we will see underperformance of the Tax Code relative to expectations—and also there are very hard to measure issue of people's faith in the Tax Code and their willingness to comply. That has emerged in recent years, I think, as the theme about concerns over the U.S. Tax Code.

The first step, of course, is to make sure if you are going to rely on voluntary compliance, that it is understandable and that there are incentives to comply; and the second step is to enforce proper auditing and collection mechanisms. I have no particular expertise in that latter category.

Mr. EMANUEL. Let me ask you another question, what you said about complexity to the sales tax, but you could also bring simplification to the tax definitions that would lead to an easier process.

Have you ever looked at the notion of a hybrid, that is X tax for X income, and basically a flat income tax for anything above a certain number, and then eliminate definitions so you get away from loopholes, phase-in, phase-out, and that you basically stop differentiating types of income? Because one of the problems is, if you look at the Tax Code especially over the last 3 years, we have made the burden harder on work and less on worth and less on capital investment.

I think that is fundamentally wrong, because when somebody gets an investment income versus what they get for salary, they don't make a distinction. Yet we are the Tax Code, and yet that is a reflection of our values.

So rather than say one is hard and the other one is easier, coming together with a hybrid that has a national sales tax, but an income tax, a flat number for all income regardless of type from that point forward.

Have you looked at a hybrid like that?

Mr. HOLTZ-EAKIN. I haven't seen that. I have seen plans that are a combination of value-added taxes, which, at least in concept, are just a multistage sales tax. It is a collection of the same base in different stages, following income tax. There are a variety of themes and variations that are out there in the literature.

Mr. EMANUEL. I will send you a copy of what has been out there just as food for thought as a way to go, maybe something to look

at as we talk about simplification. I think it is a case for simplification would add the revenue and also add to the point where others don't feel they are cheating the system while they carry a bigger burden.

Thank you, Mr. Chairman, for this hearing.

Chairman NUSSLE. Just to follow up on that, does the complication itself make it difficult for enforcement? I mean, it is probably just as obvious that it is difficult to pay the tax because of the complication; it is also difficult to enforce the Tax Code because of complication as well?

Mr. HOLTZ-EAKIN. Certainly. With respect to sales taxes, labeling something a sales tax does not necessarily make it simpler. The States' experience in trying to administer their sales tax, I think, is very illustrative. There are the same kinds of complexities and difficulties, particularly if one does not choose to make it comprehensive and tries to carve out typical classes of sales, like medical necessities, and the dividing line between necessity and purchase becomes harder. Complexity will depend not so much on the label, but on the form the tax takes, whether it is a sales tax or another type.

Mr. EMANUEL. That will then also apply—if you don't mind, Mr. Chairman?

Chairman NUSSLE. No.

Mr. EMANUEL. If you apply it on income, to somehow having definitions of income, therefore, would actually help you lower the rate as long as it was universally applied?

Mr. HOLTZ-EAKIN. Yes. There is no question, whether income or consumption tax. One of the first things that one teaches in tax policy is that we have a constitutional amendment that made taxing income possible, but it doesn't define taxable income.

Mr. EMANUEL. Thank you, Mr. Chairman.

Chairman NUSSLE. Mrs. Capps.

Mrs. CAPPS. Thank you, Mr. Chairman, for calling this hearing.

The 2 years I have been on the Budget Committee, we have been struggling with or dealing with a budget deficit that has been exploding during this current leadership. Given that our children and grandchildren will be paying for it, we all want to focus on what we can do to bring it under control, assuring that we have the most accurate estimates of revenues as part of that picture.

As my colleague Mr. Baird has pointed out, it is tough to know how to get something when you are driving blindfolded and don't have the data in front of you.

Thank you very much to all of our witnesses for your testimony, but especially Mr. Holtz-Eakin.

Last night I was reading a paragraph from your testimony that I would like to quote from, because I believe—and you have said it this morning, it reflects the priorities we have in mind when constructing the budget. This is what you say: "The central role of the government is to provide service to the public that only it can provide or provide adequately. Therefore, the threshold budgetary decisions faced by policymakers about which services to provide and how much to spend on them. These expenditures must be financed, and the challenge is for tax policy is to provide adequate financing in a fair and efficient fashion."

I think you have laid out a process, which is good. First, figure out what our government needs to do; second, figure out how much it will cost; and third, figure out how to pay for it. But unfortunately we now find ourselves in the position with our current leadership that we have first figured out what kind of tax cuts to push. We then have a deficit that we have to face, and then we come to the body and say the deficit is forcing cuts, and we get down to programs like military housing and others that we have really wrestled with here and made, I believe, the wrong—because of the wrong kind of priorities—the wrong kind of decision.

I want to focus now and ask you a question, finally, on two of the provisions we use in budgeting, which make it difficult, I think, to assess revenues. Over the past 3 years the Congress and President have tried to shoehorn the maximum amounts of tax cuts into what budget limits we have had by using phase-ins and sunset provisions. The result has been a measured cost that was only a small fraction of what the Treasury would lose if those tax cuts were put out in full effect and continued indefinitely. The proponents of these tax cuts, of course, have every intention that the cuts become permanent even while writing the provisions that make the law expire.

My question will be what will be the additional as yet unmeasured cost if all of the 2001–03 tax cuts become permanent?

Mr. HOLTZ-EAKIN. I don't remember the exact number, but I am sure that in our March report or January report we showed the implications for the 10-year budget window for extending all of the tax cuts. It is on the order of 2 percent of GDP out in 2014 or a little bit above. We could certainly get you the number.

Mrs. CAPPS. Alright. I appreciate that.

Then I guess my second question is—because we are about budgeting in this committee—what do those sunset and phase-in provisions do to the evolving revenues, which is the heart of what you are about?

Mr. HOLTZ-EAKIN. As I mentioned in my opening remarks, it really has presented us with some great difficulties in understanding the future path of, first, the economy—what does the private sector believe about the future of tax policy? And then, conditional on that, what is the best way to present the budgetary implications: following current law, which might not be consistent with the economy, or projecting the economy in a way that is not consistent with what the private sector expects and put the law on top? It has been a tough call.

Mrs. CAPPS. Again, as my colleagues have said, you wouldn't be able to run a business this way. One could say, if one is cynical, it is an attempt to cloud and make fuzzy as to what our budget situation is, because certain things are being phased in over time, and other things are being sunsetted out.

In actuality it is a gimmick, and you are faced with having to try to make some sense out of it. I think it is really hard for us to understand. I think it is even harder for our constituents to get a handle on it.

Would you mind, for one final question in the few seconds that I have, to tie this feature of our budgeting process to what difference it would make if we did really apply, as my previous ques-

tioner asked you about the pay-as-you-go method, to both taxes and spending revenues? If this were applied to taxes, what would it do to the phase-in and phase-out qualities that we now have there?

Mr. HOLTZ-EAKIN. From the perspective of CBO, that is not really the central issue. What we are trying to do in our baseline projections is give you a neutral benchmark against which you can measure policy changes, to take the current law and do our best to extract implications, thus allowing you to measure impact on a bill-by-bill basis. PAYGO would apply in that bill-by-bill basis—on any decisions you might make, PAYGO would apply to that, to that bill-by-bill decisionmaking and those things that the Congress chose to do or chose not to do. It is hard for me to speculate how that would play out.

Mrs. CAPPS. I think we make your job tougher than it should be. I yield back the balance of my time.

Chairman NUSSLE. Thank you, gentlelady.

Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

The next panel will have Ms. Olson on the roster. I think she has perhaps given this committee two of the most important sentences to testimony that I have seen in my tenure on the committee. I would like to read those aloud.

It refers to tax loopholes. Of course, a loophole is what somebody else gets, but if you get it yourself, it is an element of essential tax fairness. She says, “In recent years the Internal Revenue Code has been amended repeatedly with provisions intended to encourage, reward or reduce the costs of certain activities through exclusions, deductions, exemptions, special rates and credits. While the goals of some of the provisions may be admirable, they represent uncapped, unverified and, in a large measure, unverifiable direct spending programs.”

That is a powerful statement to me, because it basically means that these tax expenditures or tax loopholes make it almost impossible for someone like you to estimate. So that means, to me, that the worst direct spending program is still probably preferable to the best indirect spending program, because at least you can measure and verify the direct spending program.

But these indirect spending programs through the Tax Code amount to a blank check, because if they are uncapped, unverified and unverifiable, we have lost complete control, and almost every day in this body we are tempted by some group or another to give them a tax break. To our friends on the Ways and Means Committee, those will seem like real deals.

I know that President Reagan and others had a thing that “there was no such thing as a tax expenditure, it was all your own money anyway,” and some of my friends on the other side may perhaps believe this. But for Ms. Olson to say this, and I believe she was a political appointee of the Bush administration, the George W. Bush administration, to me, she is speaking the truth.

This spending is uncapped, unverified and unverifiable. That is perhaps the most damning statement I have ever heard, and yet this Congress and previous Congresses engaged in these programs wholesale.

So, what am I missing here? Do you have a secret mechanism for verifying these unverifiable spending programs, the number of which we could barely count if we had an encyclopedia? In fact, most of the documents that are listed over there are full of these very loopholes. So we don't even have a clue about how much revenue we are missing or how much of a subsidy we are offering to these individual beneficiaries.

If these are, in fact, as Ms. Olson is about to testify, uncapped, unverified and unverifiable, what am I missing?

Mr. HOLTZ-EAKIN. I will leave Ms. Olson to defend her alliteration. I think the issue is an important one. As I said, just at the conceptual level, presenting a budget where you can make trade-offs and see all programs for their resource cost is important, and the degree to which things are treated differently on one side or the other is not helpful, at our end, when one does these targeted sorts of tax policies. That falls into that very difficult category of technicals. It is a composition of activity in the economy not captured by just whether—we have got full employment GDP. When we are wrong, we have technical restimates, and we see that all the time.

Mr. COOPER. Dr. Olson—in your little time remaining, I think what—you are mistaken here. I am talking about what Ms. Olson seems to be claiming are the biggest loopholes in American history. These are uncapped spending programs, unverified and unverifiable. How on Earth do the advocates of these loopholes know what they are costing? How can you make a cost/benefit analysis if you have no idea of the cost?

You know, this is uncharted water, it seems like, if Ms. Olson is correct, and she was a top trusted official in this administration. This is to say one of the most damning statements I have ever heard, and she has been brave enough to put it in plain English. She is, I assume, on the other side of the aisle. This is an amazing thing. These loopholes you are describing are so big you could drive a truck through them.

There is barely enough law left to hold all the loopholes together if her claim is verified, uncapped, that these programs are unverified and unverifiable. You are making some nice, technical-sounding statements, but if her claims are correct, you cannot do your job with thousands of these in the budget, in the Tax Code.

Mr. HOLTZ-EAKIN. Again, to look at the details, I am looking at the cost in a budget sense. In the sense of introducing such a tax loophole that would be a job that the Joint Committee on Taxation would have to do, and that is a highly professional group. They will do the best they can under these circumstances.

Mr. COOPER. Which is no good. Which is no good.

Mr. HOLTZ-EAKIN. Your characterization.

Mr. COOPER. Well, Ms. Olson's.

Mr. HOLTZ-EAKIN. Ms. Olson's.

At the CBO we don't have to do that. We have to take that law when it is in place and project what will be collected. We do not have to calculate how much of the loss is variable behavior. What we have to do may be hard, but not as hard as that particular problem. These are very difficult projections in the revenue projections.

Mr. COOPER. Say you had a special mortgage tax break for blue houses, you got a double mortgage deduction. Wouldn't you get—you would have a lot more blue houses?

Mr. HOLTZ-EAKIN. Absolutely.

Mr. COOPER. People would suddenly like that color. Then in order for you to do your job, you would have to count the number of blue houses and new blue houses in America in order to estimate the revenue you could anticipate. Who is out there doing that counting? No one.

These are uncapped, unverified and unverifiable spending programs through the Ways and Means Committee, not the Appropriations Committee, which is a much more accountable body. So this to me is an outrage. But my time is up.

Chairman NUSSLE. Reserving the right to object on the question of whether the Appropriations Committee is more accountable than Ways and Means. Yes, we won't go there.

Mr. COOPER. Seriously, Mr. Chairman.

Chairman NUSSLE. You don't have to make up an example about blue houses. There is the earned income tax credit that probably may be the mother of all good examples.

Mr. Diaz-Balart.

Mr. DIAZ-BALART. Thank you, Mr. Chairman.

I have the highest respect particularly for colleagues in this committee, but I think all of us, including me, we kind of get confused by our own minutiae. The government tends to do that a lot. I have just heard, for example, tax cuts are a gimmick. In other words, the government taking less money from the American people is a gimmick.

We all know government taking less money from hard-working Americans is government taking less money from hard-working Americans; by the way, doesn't stimulate the economy. I think there is a consensus on that.

But also, now, I am rather kind of concerned about this unverifiable amount of money that I guess we have in tax cuts, I guess, if all we are concerned about is government, and then we should probably just take every single penny that Americans earn, and then we could definitely verify how much money there is. But ultimately, again, we have to remember that the people in small business and hard-working Americans are not here to serve governments. Government is here to supposedly serve the people.

So the fact that—and I know it wasn't many members of this committee that actually made that original quote, but the fact that this thing about unverifiable, again, that we can't verify, and it is unverifiable, and it is unverified, it would seem to me that if that is the—heck, let us just take everybody's money, 100 percent of it, because if we are concerned about—if the only thing we are concerned about is how much the government can figure out how much we are or are not taking, and that is what we are concerned about, man, we are getting the wrong role rule here. The role should be to take every penny.

The bottom line is, the reason I mention that, I think we sometimes get confused in our own minutiae, and the bottom line is tax cuts are taking money from the American people. Tax cuts in the complicated Tax Code is again taking less money from American

people, and I agree that is not spending it. When you take less money from the American people, that is not spending; the government isn't spending anything, but we are taking less of their money.

And I do have a question. You know, one of the things that is interesting is that the alternative minimum tax that was enacted in the 1970s has obviously been expanded periodically, has never been indexed, as far as I know, to inflation. As a result my understanding and projections indicate a massive growth of the number of taxpayers paying the AMT in the future, which would make sense. Does that AMT complicate revenue projections? And also it would seem that predicting what the taxpayers will have to pay, how much AMT, would be difficult. Is that correct; is that accurate?

Mr. HOLTZ-EAKIN. The AMT is another part of our challenge, for revenue projections. We have the AMT rising to nearly 30 million taxpayers in our baseline. Again, we look at the composition of their income, look at the composition of their deductions, and then look to see whether it will be on the AMT based on nominal incomes, because the AMT is not indexed.

Mr. DIAZ-BALART. Mr. Chairman, we have seen again—looks like from 2001—the errors in the CBO projections that resulted more from economic factors, assumptions and technicals than from actual legislation, and that is what my understanding is. Is there anything we can do regarding our tax system to reduce those economic and technical forecasting errors, or is that something that is beyond our control?

Mr. HOLTZ-EAKIN. I think that the underlying economic uncertainty, the fact that there are business cycles over that period—it is a particularly difficult period because of a turning point which is very hard to forecast. But, in general, that part won't go away.

Technicals depend in many ways on these policy issues where you have incentives to shift the composition of your activity, or that the Tax Code explicitly favors one activity over another. Having those simplified might help somewhat, along with better data. Simply having more information to both permit the analysis of past technical errors and also timely projection of the likely future of tax receipts—those are all things that would help.

We have worked very hard at CBO to try to understand this better. We had a conference last year. We brought in experts on literally the year-by-year technicals and examined what the nature of the construction of those were—top down, bottom up, the use of supplementary information from States, a wide variety of issues. Nothing stood out as a silver bullet. I mean, this is just a hard area.

Chairman NUSSLE. I thank you.

Director, thank you very much for your testimony today. As we move forward, I think you can tell from a bipartisan smattering of questions and comments that we are interested in getting better data. If CBO has any recommendations regarding giving data, whether that is access to better information from whether its Treasury or Joint Tax, whatever it may be, we want to make sure that the Congress has the best information in order to make decisions. It may not be day old or week old or even monthly, but 3 years is difficult. And as we have heard today, I think Members are

interested in doing what we can, even if it required internal or legislative changes that we can make in order to get better information. So we appreciate that.

If you have recommendations, we would be very interested in receiving them as we move forward.

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman.

Chairman NUSSLE. I thank you.

Now we will invite the second panel to come forward. We have three distinguished panelists, the Honorable Pam Olson, Dr. Peter Merrill and Dr. William Gale, and we will take a brief 2-minute recess while we are changing the names and inviting our guests to come forward.

[Recess.]

Chairman NUSSLE. Our second panel, we are pleased to have at the panel table. We are pleased, I am pleased, to invite Pam Olson, often quoted. We appreciate you being here, we appreciate your service.

As a member of the Ways and Means Committee, I have to say, I was always very appreciative of your testimony before our committee as Under Secretary. We miss you, but we are certainly glad to have you here today to be able to present us with your ideas regarding revenues projections. So you may proceed as you see fit.

**STATEMENTS OF PAMELA F. OLSON, PARTNER, SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY; PETER R. MERRILL, PH.D., DIRECTOR, NATIONAL ECONOMIC CONSULTING GROUP, PRICEWATERHOUSECOOPERS LLP; AND WILLIAM G. GALE, Ph.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION**

**STATEMENT OF PAMELA F. OLSON**

Ms. OLSON. Thank you, Mr. Chairman, for that warm welcome, a welcome maybe a little warmer than I would have liked. Mr. Chairman, Mr. Spratt and members of the committee, I do appreciate the opportunity to be here to discuss the tax system, particularly on the budget side.

The ideal tax system would raise the revenue to fund the operations of the government with the least adverse impact on the economy. It would be neutral, transparent, stable and certain. Our tax system falls short of the ideal system in several respects, and it is those shortcomings my testimony addresses. Before turning to that topic, however, it would be useful to focus for a moment on the budgetary impact of the increasing tendency to spend through the Tax Code. We have already heard a little bit about that in this hearing.

I guess I won't reread the two sentences that have already been read into the record, but let me explain what I meant by uncapped, unverified and unverifiable. Expenses or amounts that we spend through the Tax Code are uncapped because any taxpayer satisfying the applicable requirements may claim the resulting tax deduction or outlay. While targeting the benefits of the provisions to particular classes of taxpayers may hold down the budgetary im-

pact, it does so at the expense of simplicity, a point that is worthy of further discussion.

The multiplication of these provisions prompted a waggish Treasury Department economist a few years back to design the “tax credit for the taxpayer who didn’t get a tax credit” in an effort to stave off the development of further credits.

These spending programs are unverified because taxpayers need not establish to the Internal Revenue Service their eligibility for the tax reduction or outlay before claiming it on their tax return. They are largely unverifiable because neither the Treasury Department nor the Congress has been able to devise mechanisms that would permit the Internal Revenue Service to efficiently and effectively determine taxpayers’ eligibility for the special provisions. There is, of course, an IRS audit program, but as we have heard an awful lot in the press lately, we don’t begin to cover the number of taxpayers that we perhaps ought to be covering. Certainly we will never get to the point where we cover them all, at least not so long as we insist on adding complications to the Code that can’t be readily verified by information provided by a third party, for example.

This inability to verify presents another serious issue for the Congress. We cannot assess the efficacy of the expenditures in achieving our desired goals.

As the late former Treasury Secretary William Simon observed, the United States should have a tax system which looks like someone designed it on purpose. No tax system ever devised has included so many things unrelated to tax collection. While one or two exceptions might be reasonable, the weight of all the exceptions puts at risk the basic goals of the tax system.

Spending through the Tax Code presents particular challenges to our ability to make accurate budgetary projections. It also affects economic growth and, this is really important, deprives the tax system of the neutrality, transparency and certainty that would make for a better system.

With respect to minimizing the impact of the tax system on the economy by, removing resources from the private sector, the tax system slows the growth of the private sector of the economy. If we want to minimize the effect on the economy, we should have a system that minimizes its impact on decisions to work, save and invest. We can best foster economic growth with low rates, a broad base—that is, few exceptions, equally applied—eliminating barriers to deploying and redeploying capital and labor and a stable system.

The amounts that we spend through the Tax Code have considerably narrowed the tax base in recent years, particularly since we did a house cleaning back in 1986. The myriad sunsets of current law are the opposite of the stability that allows taxpayers to plan their affairs.

It is important to have a system that is as uncomplicated as possible, a standard that the current Tax Code fails miserably. Resources spent complying with the tax laws, which the Internal Revenue Service estimates for individuals alone—this is the issue that was raised earlier—totaled between \$70 [billion] and \$95 billion annually. These are resources that are unavailable for more productive investments and endeavors and are a drag on the economy.

Turning now to the other principles that should guide us in designing our tax system. First, neutrality. The tax system should apply on a neutral basis, that is, without discriminatory treatment. Investment decisions made on a basis other than maximizing pretax returns reduce national income to the detriment of all. The best rules are rules that apply equally without regard to industry, activity, type of entity, or form of investment. The Internal Revenue Code fails the neutrality principle on multiple scores.

Second, transparency. Transparency in the tax system has been described as certainty about what the rules are, how they will be applied, and that they will be applied fairly. Transparency matters because it gives taxpayers confidence in the system. A system that is too complex loses its transparency because of the difficulty of administering and complying with it. That, in turn, will erode confidence in the system and voluntary compliance.

The U.S. tax system is nothing short of opaque; that is, the opposite of the transparent system we should be seeking. It is impossible for any one person to understand all of the Tax Code's provisions, and the Internal Revenue Service cannot assure compliance or consistent application.

It is my view that the growing complexity of the system has reduced compliance because many taxpayers simply throw up their hands in despair. Perhaps even more important is that complexity creates shadows, concealing those inclined to avoid their responsibilities. In short, the opacity of the current system is a danger to our self-assessment system.

Third, certainty. Decisionmaking is difficult. This committee is certainly aware of that. Decisions involve expectations about the future, but the future is uncertain. The greater the uncertainties, the greater the risk. The greater the risk, the greater the premium required by the decision maker. We can reduce decision makers' risk premiums by giving them greater certainty about the future. At a minimum, we should not add to the risk premium attached by the decision maker with provisions that go in and out of the Tax Code like yo-yos. A system that is stable will reduce the risk premium and result in more productive decisions.

There are particulars I want to draw to the committee's attention. The first relates to the efficacy of spending through the Tax Code.

Simply stated, the Tax Code is not a good delivery vehicle for many of the programs we have added over the years. In order to deliver the benefits intended by the various spending provisions added to the Tax Code, a taxpayer must be aware of the benefits and capable of claiming them, and the Internal Revenue Service must be capable of administering them. The complexity of the Tax Code, coupled with the educational level of many of the individuals to whom benefits are targeted, makes the Tax Code a poor delivery mechanism for many intended benefits. The fact that eligibility is determined after benefits are claimed adds an unhealthy uncertainty about whether an outlay will have to be repaid or whether additional taxes might be due at some point down the road.

Benefits delivered through the Tax Code are sometimes highly particularized, requiring the Internal Revenue Service to make determinations about eligibility that it is without the expertise to

make. Consider, for example, the expertise required to administer provisions in the tax laws relating to the environment, conservation, or energy production. The resources required to administer such provisions appropriately are significant and detract from the Internal Revenue Service carrying out its primary tax collection function.

The second relates to projecting corporate receipts. Over time corporate receipts have proved difficult to project and a volatile source of revenue. Receipts' trending down in an economic downturn is desirable because of the countercyclical effect, but it may be advisable to consider whether there is a base that would produce more predictable revenues than our current income tax base does.

I was interested to hear the question about the difference between financial statement reporting and the amounts reported on tax returns. As the years have passed, we have increased the number of disparities between book income and taxable income. And taxpayers do have to follow the tax laws when preparing their returns. Removing the disparities between financial statement incomes and taxable incomes might reduce some of the volatility that we see. It might also have the effect of making it easier for corporate tax receipts to be projected. On the other hand, an entirely different base might be considered, such as a business activities tax.

Finally, our current savings rate is abysmal. It seems clear that the complexity of the savings provisions in the Tax Code prevents many taxpayers from taking advantage of those opportunities. Some complexity stems from the best of intentions: the desire to provide as many options as possible. As behavioral economists have demonstrated, however, having too many options can actually reduce the take up rate. Taxpayers spend too much time trying to understand their options under the tax rules. It would be better if they put that time into making wise investment decisions. If we want people to get off the spending couch and into the savings gym, we need to make it easier for them to do so.

Although our tax system is sometimes said to be a hybrid of income and consumption taxes, it favors spending over saving except to the extent that taxpayers can avail themselves of the complicated and illiquid savings provisions in the tax law. In other words, under our tax law today, virtue carries a cost rather than a reward. Although current budget shortfalls dominate many discussions, the long-term shortfalls stemming from unchecked Medicare and Social Security spending is a far more serious problem. The problem can be eased by increasing our savings rate. That means creating a Tax Code that encourages, not penalizes, those who save.

I would be happy to answer the committee's questions.

[The prepared statement of Ms. Olson follows:]

PREPARED STATEMENT OF PAMALA F. OLSON, PARTNER, SKADDEN, ARPS, SLATE, MEAGHER & FLOM, LLP, FORMER ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Chairman Nussle, Ranking Member Spratt, and distinguished members of the Committee, I appreciate the opportunity to appear this morning to discuss current problems facing our tax system. I am here today at the request of the Committee.

I am currently a partner in the law firm, Skadden, Arps, Slate, Meagher & Flom, LLP, but I am not appearing on behalf of any client or other organization, and the views I offer are solely my own.

#### I. INTRODUCTION

The ideal tax system would raise the revenues to fund the operations of the government with the least adverse impact on the economy—that is, it would be neutral, transparent, stable, and certain. Our tax system falls short of the ideal system in several respects, and it is those shortcomings my testimony addresses. Before turning to that topic, however, it would be useful to focus for a moment on the budgetary impact of the increasing tendency to “spend” through the Tax Code.<sup>1</sup>

#### II. SPENDING THROUGH THE CODE

In recent years, the Internal Revenue Code has been amended repeatedly with provisions intended to encourage, reward, or reduce the cost of certain favored activities through exclusions, deductions, exemptions, special rates, and credits.<sup>2</sup> While the goals of some of the provisions may be admirable, they represent uncapped, unverified, and, in large measure, unverifiable indirect spending programs. They are uncapped because any taxpayer satisfying the applicable requirements may claim the resulting tax reduction or outlay. While targeting the benefits of the provisions to particular classes of taxpayers may hold down the budgetary impact, it does so at the expense of simplicity, a point worthy of further discussion.

They are unverified because taxpayers need not establish to the Internal Revenue Service their eligibility for the tax reduction or outlay before claiming it on their tax returns. They are largely unverifiable because neither the Treasury Department nor the Congress has been able to devise mechanisms that would permit the Internal Revenue Service efficiently and effectively to determine taxpayers’ eligibility for many of the special provisions.

The inability to verify presents another serious issue: We cannot assess the efficacy of the expenditures in achieving the desired goals.

As the late former Treasury Secretary William Simon observed, “The United States should have a tax system which looks like someone designed it on purpose.” No tax system ever devised has included so many things unrelated to tax collection. While one or two exceptions might be reasonable, the weight of all the exceptions puts at risk the basic goals of the tax system.

Spending through the Tax Code presents particular challenges to our ability to make accurate budgetary projections. It also affects economic growth and deprives the tax system of the neutrality, transparency, and certainty that would make for a better system, points to which I will now turn.

#### III. MINIMIZING THE TAX SYSTEM’S ADVERSE IMPACT ON THE ECONOMY

By removing resources from the private sector, the tax system slows the growth of the private sector of the economy. Minimizing the effect on the economy requires a system that minimizes its impact on decisions to work, save, and invest.

We can best foster economic growth with low rates, a broad tax base (i.e., few exceptions equally applied), eliminating barriers to deploying and redeploying capital and labor, and a stable system. The amounts spent through the Tax Code (discussed previously) have narrowed the tax base. The myriad sunsets of current law are the opposite of the stability that allows taxpayers to plan their affairs.

It is important to have a system that is as uncomplicated as possible, a standard the current Tax Code fails miserably. Resources spent complying with the tax laws, which the Internal Revenue Service estimates for individuals alone total between \$70 billion and \$95 billion annually, are resources unavailable for more productive endeavors and are a drag on the economy.

The Tax Code’s adverse effect on economic growth deserves Congressional attention.

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<sup>1</sup> The Treasury Department and the Joint Committee on Taxation each prepare an annual tax expenditure analysis, which is far broader in concept than the issues described below. The Treasury Department has devoted considerable effort in recent years to revising its tax expenditure analysis, some of which is described in the President’s two most recent Budgets, to address inconsistencies and limitations of the analysis.

<sup>2</sup> What appeared to be an effort a few years back to “put a tax credit in every pot” led a Treasury Department economist to design the “tax credit for the taxpayer who didn’t get a credit” in an effort to stave off further proposals.

#### IV. NEUTRALITY

The tax system should apply on a neutral basis, that is, without discriminatory treatment. Investment decisions made on a basis other than maximizing pre-tax returns reduce national income to the detriment of all. Consequently, we should avoid rules that discriminate, thus biasing investment decisions. The best rules are rules that apply equally, without regard to industry, activity, type of entity, or form of investment. The Internal Revenue Code fails the neutrality principle on multiple scores.

#### V. TRANSPARENCY

Transparency in a tax system has been described as certainty about what the rules are, how they will be applied, and that they will be applied fairly.<sup>3</sup> Transparency matters because it gives taxpayers confidence in the system. A system that is too complex loses transparency because of the difficulty of administering and complying with it. That, in turn, will erode confidence in the system and voluntary compliance. It goes without saying that reduced compliance means higher tax rates for compliant taxpayers.

The U.S. tax system is nothing short of opaque, that is, the opposite of the transparent system we should be seeking. It is impossible for any one person to understand all of the Tax Code's provisions, and the Internal Revenue Service cannot assure compliance or consistent application. Using income for our tax base ensures some complexity because income is inherently difficult to measure. However, we have exacerbated the problem with special rules that increase the disparities between taxable income and conventional determinations of income, such as financial statement income.

Although reliable information on compliance levels is hard to come by, it is my view that the growing complexity of the system has reduced compliance because many taxpayers simply throw up their hands in despair. The multitude of special provisions leaves taxpayers uncertain whether they have correctly claimed the allowable tax benefits, worrying they have missed some hidden provision, and wondering whether they paid more than their fair share. Perhaps even more important is that complexity creates shadows concealing those inclined to avoid their responsibilities.

In short, the opacity of the current system is a danger to our self-assessment system. Although the decline of the tax system on account of complexity has been predicted for decades, I believe that we are at a critical juncture. If we do not begin soon with significant steps to simplify the tax laws, I believe the system may collapse of its own weight.

#### VI. CERTAINTY

Decision-making can be difficult. Decisions involve expectations about the future but the future is uncertain. The greater the uncertainties are, the greater the risk is. The greater the risk is, the greater the premium required by the decision-maker. We can reduce decision-makers' risk premiums by giving them greater certainty about the future. At a minimum, we should not add to the risk premium attached by the decision-maker with provisions that go in and out of the Tax Code like yoyos. A system that is stable will reduce the risk premium and result in more productive decisions. I would urge you to go to work now to create a tax system that is not subject to annual revision.

#### VII. PARTICULARS

I want to note for the Committee three particular budget issues.

The first relates to the efficacy of spending through the Tax Code. In order to deliver the benefits intended by the various spending provisions added to the Tax Code, the taxpayer must be aware of the benefits and capable of claiming them, and the Internal Revenue Service must be capable of administering them. The complexity of the Tax Code coupled with the educational level of many of the individuals to whom benefits are targeted makes the Tax Code a poor delivery mechanism for many intended benefits. The fact that eligibility is determined after the benefits are claimed adds an unhealthy uncertainty about whether an outlay will have to be repaid or additional taxes will be due at some point down the road.

Benefits delivered through the Tax Code are oftentimes highly particularized, requiring the Internal Revenue Service to make determinations about eligibility that it is without the expertise to make. Consider, for example, the expertise required

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<sup>3</sup>A transparent system is the opposite of one in which the taxpayer negotiates his tax liability.

to administer provisions in the tax laws relating to the environment, conservation, or energy. The resources required to administer such provisions appropriately are significant and detract from the Internal Revenue Service carrying out its primary tax collection function.

The second issue relates to projecting corporate receipts. The fact that corporate receipts have declined as a percentage of all receipts has received considerable attention of late. The decline may be traced to a number of factors:

- The growth of pass-through entities such as partnerships that has shrunk the corporate sector's share of gross receipts.
- Expensing of stock options.
- Increased use of indebtedness as a more tax efficient capital structure.
- A decline in corporate profitability.

Over time, however, corporate receipts have proved difficult to project and a volatile source of revenue. Receipts' trending down with an economic downturn is desirable because of the countercyclical effect, but it may be advisable to consider whether there is a base that would produce more predictable results than our current corporate income tax base does. Removing disparities between financial statement and taxable income might reduce some volatility. An entirely different base, such as business activities, might be considered as well.

Finally, our current savings rate is abysmal. It seems clear that the complexity of the savings provisions in the Tax Code prevents many taxpayers from taking advantage of those opportunities. Some complexity stems from the best of intentions: the desire to provide as many options as possible. As behavioral economists have demonstrated, however, having too many options can actually reduce the take up rate.<sup>4</sup> Taxpayers spend too much time trying to understand their options under the tax rules. It would be better if they put that time into making wise investment decisions. If we want people to get off the spending couch and into the savings gym, we need to make it easier for them to do so.

Although our tax system is sometimes said to be a hybrid of income and consumption taxes, it favors spending over saving except to the extent taxpayers can avail themselves of the complicated and illiquid savings provisions in the tax law. Over time, for example, two families who are identical except that one saves diligently will bear different tax burdens. The family that saves will see its income tax burden increase relative to the burden of the taxpayer who spent. In other words, virtue carries a cost, not a reward. Although current budget shortfalls dominate many discussions, the long-term shortfall stemming from unchecked Social Security and Medicare spending is a far more serious problem. The problem can be eased by increasing our savings rate. That means creating a Tax Code that encourages, not penalizes, those who save.

Thank you for inviting me to testify today. I would be happy to answer any questions.

Chairman NUSSLE. I thank you for your testimony, and the warm welcome was meant—I can tell just again by your testimony today versus when you maybe had your hands tied speaking a little bit just for the administration, it is even better. So I appreciate it.

Dr. Merrill, welcome to the committee, and we are very pleased to receive your testimony. Just so everyone knows, your full testimony will be made part of the record, and you may proceed as you see fit.

#### **STATEMENT OF PETER R. MERRILL**

Mr. MERRILL. Thank you, Mr. Chairman, Mr. Spratt and members of the committee. I am Peter Merrill, director of the National Economic Consulting Group of PriceWaterhouseCoopers. I am testifying today on my own behalf and not as a representative of any organization. The focus of my testimony is on the competitiveness

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<sup>4</sup>In an upscale grocery store experiment, researchers set up a jam-tasting booth, first with six jars of jam from which shoppers could choose, and then with 24 jars of jam. When the shoppers had only six jars from which to choose, 40 percent tasted and 30 percent made a purchase. When the number was increased to 24, the percentage tasting increased to 60 percent, but the number buying dropped to 3 percent. More choices are not always better.

of the U.S. tax system, how it compares with the tax systems of other major industrial countries.

In the global economy, tax policy is one of the ways that the United States competes for investment at home and for the success of U.S.-owned companies abroad. The United States is a relatively low-tax country, according to OECD statistics. Federal, State and local combined was lowest among the OECD countries in 2001.

The favorable tax burden reflects the smaller role that the government plays in the United States economy. Government expenditures relative to GDP also were fourth lowest among the OECD countries. According to the 2001 OECD statistics, the U.S. Government's public debt as a share of GDP was less than the OECD average by about 12 percentage points. However, based on CBO projections, the U.S. public debt-to-GDP ratio will exceed the current OECD average within the next 10 years if all the expiring income tax relief projections in the Code are extended.

While the United States is a relatively low-tax country, it relies more heavily on taxes on income and profits, both as a share of total taxation and as a share of GDP, than the average OECD country. Combining all levels of government, income and profits taxes accounted for about half of U.S. revenues in 2001 compared to 36 percent for the average OECD country. At the Federal level the government is even more reliant on income and profit taxes as there is no broad-based Federal consumption tax as there is in every other OECD country.

The top Federal U.S. tax rate on individual income is now 30 percent, less than the OECD average of 37.6 percent. However, unlike most of the OECD countries, U.S. residents typically are subject to income tax on State or local levels of government. Unless it is extended, the top individual Federal income tax rate will increase from 35 to 39.6 in 2011, to put the top Federal individual income tax rate at 2 percentage points above the current average for OECD countries.

Immediately following the Tax Reform Act of 1986, which lowered the U.S. income tax rate from 46 to 34 percent, the U.S. corporate rate was quite attractive. This is no longer true. The U.S. corporate income tax rate increased to 35 percent in 1991, while the average OECD country's corporate rate fell to 29.3 percent in 2003. In other words, the average OECD country's average tax rate is 5.4 percent percentages points less than the U.S. rate. If you look at the 25 members of the newly expanded European Union, the average corporate tax rate is about 27 percent, 8 percentage points less than the U.S. corporate rate. The U.S. is tied with Spain and Greece for third highest corporate income tax rate among OECD countries. High corporate income tax rates discourage businesses from operating in regular corporate form.

While the 2003 Tax Act reduced the shareholder level tax on corporate tax dividends, this relief is scheduled to sunset after 2008. If it does sunset, the U.S. will join Switzerland as the only OECD country without double taxation relief, and the top rate on income tax on dividends, combining Federal and individual-level taxation, would increase from about 45 percent today to 60 percent after 2010.

Payroll taxes provide, of course, a primary source of funding to the U.S. for the Social Security, Medicare, and unemployment systems. The social insurance and payroll taxes represent about one-fourth of revenues in the United States, which is actually quite similar to other OECD countries.

Like many other advanced industrial economies, the future obligations of the U.S. social insurance system exceed the dedicated revenue streams. In 2003, the GAO estimated that future liabilities for the U.S. Social Security and Medicare systems would exceed future revenues for these programs by about \$21 trillion in present value, and that didn't include the Medicare prescription drug expansion that was done this year. That unfunded liability is about 71,000 for every U.S. citizen. So it is obviously a significant long-term challenge.

Looking at multinationals, the United States imposes higher taxes on U.S.-based multinationals than competitor countries impose on their multinationals. As a result, U.S. multinationals will lose global market share.

A decline in global market share of U.S. multinationals will obviously affect domestic workers—I will not go into all of the written testimony on this—but competitiveness of U.S. multinationals abroad is directly related to employment at home.

Aside from the relatively high U.S. corporate income tax rate, there are a number of other features of the U.S. system of taxing foreign-source income that depart from international norms. Over half of the OECD countries have dividend exemption, or so-called territorial tax systems, under which the parent company generally is not subject to tax on the income earned by its foreign subsidiaries.

The U.S. foreign tax credit, which is intended to limit or prevent double taxation, has a number of defects that increase the complexity and prevent double tax relief.

Moving to complexity, the burden of the tax system includes both taxes paid and compliance costs. The Tax Foundation has estimated that the cost of complying with the Federal income tax raises the total tax burden by about 20 percent, that is, 194 billion in 2002. There are lower estimates of this as well; they vary on how you value the time that people spend filling out returns.

Just by comparison to a 20 percent compliance cost, typical estimates of the cost of complying with consumption taxes are on the order of 3 to 4 percent of revenue.

One source of complexity that has been mentioned here several times earlier today is the alternative minimum tax which requires calculation of tax liability under two different systems. In principle, dual calculation is required whether or not you actually owe the AMT. The individual AMT is becoming far more pervasive because the dollar amount of the AMT exemption was not indexed in 1986 and the regular tax rates, but not the AMT rate, were reduced in 2001, as Doug Holtz-Eakin told you earlier, CBO estimates that by 2010 there will be 29 million households that face AMT one way or another.

Fixing the AMT is a very serious budget challenge. CBO has estimated it would cost about 400 billion to index the AMT exemption to 2004 levels over the next 10 years.

Another source of complexity that has been mentioned before is Tax Code instability. The frequency of change in the Tax Code imposes costs, as Doug Holtz-Eakin mentioned, it affects taxpayer behaviors in ways that are very difficult to predict. According to the Tax Foundation, from 1995–2000, the Tax Code increased by 182 pages, which is about half the pages of the entire 1954 code. At this rate, the Code will increase from about 1,700 pages in 2000 to about 2,600 pages in 2010, and who knows where it will end.

Tax Code instability is also due to the adoption of tax provisions on a temporary basis to comply with budgetary scoring rules, and that is an example of how rules that were designed to promote fiscal responsibility have the unfortunate side effect of creating instability in the tax system.

In summary, U.S. residents currently pay a smaller share of GDP in total taxes than do residents of most other OECD countries. However, the present U.S. tax structure does not generate sufficient revenue to meet projected Federal spending in the long run.

Closing the fiscal gap by raising income and profit taxes would cause the U.S. tax system to depart even further from international norms, as the U.S. already relies more heavily on income and profit taxes, as I said, both as a percent of GDP and percent of total taxes, than the typical OECD country.

The cost of complying with the Federal income tax system, which is roughly 20 percent of income taxes raised, is much higher than the cost of complying with consumption taxes by most estimates. Obviously, the AMT is a very important issue in the future as a source of complexity for taxpayers.

Finally, the U.S. international rules, the rules that tax the income of our multinationals are very much out of step with competitor countries. They are very complex, and they impose very high compliance costs relative to revenue raised.

Thank you.

Chairman NUSSLE. Thank you.

[The prepared statement of Mr. Merrill follows:]

PREPARED STATEMENT OF PETER R. MERRILL, DIRECTOR, NATIONAL ECONOMIC CONSULTING GROUP, PRICEWATERHOUSECOOPERS LLP

#### I. INTRODUCTION

I am Peter Merrill, Principal and Director of the National Economic Consulting group at PriceWaterhouseCoopers LLP. I am testifying today on my own behalf and not as a representative of any organization.

The focus of my testimony is on the competitiveness of the U.S. tax system, which I assess through a comparison of the structure of the U.S. tax system with that of the 30 member countries of the Organization for Economic Cooperation and Development (OECD). In a global economy, differences in tax systems can affect international capital flows-to the benefit or detriment of a country's workers and investors.

In some instances, U.S. rules regarding the taxation of both domestic and foreign income are out of step with the tax systems used by other major industrial countries.

#### II. TAX COMPETITIVENESS IN A GLOBAL ECONOMY

Much of the U.S. tax system was developed when the United States dominated the global economy. This is no longer the case. In the 1960s, the U.S. economy represented 40 percent of global GDP and U.S. multinationals accounted for 50 percent of cross-border investment. In 2003, the U.S. economy represented 30 percent of

global GDP and U.S. multinationals accounted for less than 22 percent of cross border investment (see Exhibit 1).

The U.S. economy is also far more open to trade and investment than was the case just a few decades ago. Merchandise trade (imports plus exports) has increased from less than 7 percent of GDP in the 1960s to 18.6 percent over the last 4 years. From 1980 to 2002, the stock of U.S. direct investment abroad increased (in nominal dollars) from \$390 billion to \$1.84 trillion (370 percent), while foreign direct investment in the United States increased from \$130 billion to \$1.50 trillion (1,080 percent). The growth in the stock of cross-border portfolio investment is even more staggering. From 1980–2002, private investment in foreign securities increased from \$62 billion to \$1.8 trillion (2,855 percent), while foreign private investment in U.S. securities increased from \$90 billion to \$3.2 trillion (3,500 percent) (see Exhibit 1).

As a result of the growing importance of international capital flows, U.S. tax policy is no longer insulated from global market forces. Increasingly, one of the considerations in the design of a country's tax system must be how it compares with that of its major trading partners. And, there is little doubt that governments react to changes in the tax systems of their trading partners. For example, the reduction in the U.S. corporate income tax rate from 46 percent to 34 percent under the 1986 Tax Reform Act precipitated similar reductions in many other OECD countries. Another example is the spread of the value-added tax systems from the European Union to over 120 countries worldwide.

Competitiveness is one of a number of criteria by which to judge the U.S. tax system—other traditional criteria include fairness, simplicity, efficiency, and revenue adequacy. The focus of this testimony is on how the U.S. tax system compares with that of other major industrial countries.

### III. INTERNATIONAL COMPARISON OF TAX STRUCTURES

#### A. Aggregate Revenues and Expenditures

The United States is a relatively low tax country. According to OECD statistics, as of 2001, the total tax burden in the United States—federal, State, and local combined—was 28.9 percent of GDP, fourth lowest among the 30 OECD countries (see Exhibit 2). The favorable tax burden reflects the smaller role that government plays in the U.S. economy, where government expenditures relative to GDP were fourth lowest among the OECD countries. The publicly financed share of expenditures on health and post-secondary education generally is higher outside the United States and correspondingly greater government revenues are required to finance these outlays.

In January of this year, the Congressional Budget Office estimated that Federal Government revenues would fall short of Federal Government expenditures by 3.0 percent of GDP in fiscal year 2005, but that the Federal Government deficit would be eliminated by 2014. This forecast, however, assumes that all of the temporary provisions in EGTRRA and JGTRRA expire as scheduled and excludes the Medicare prescription drug benefit enacted earlier this year.

#### B. Aggregate Debt

According to 2001 OECD statistics, outstanding marketable debt of the United States government was less than the average OECD country by 12.7 percent of GDP.<sup>1</sup> In January of 2004, CBO projected that by 2009, Federal debt held by the public would increase by 7.6 percentage points of GDP relative to the 2001 level. This forecast assumes that all expiring provisions expire as scheduled and excludes the new Medicare prescription drug benefit.

#### C. Composition of Revenues

While the United States is a relatively low tax country, it relies more heavily on taxes on income and profits—both as a share of total taxation and as a share of GDP—than the average OECD country. Combining all levels of government, income and profits taxes accounted for about 48 percent of U.S. revenues in 2001 as compared to 36 percent for the average OECD country (see Exhibit 3). Income and profits taxes collected at all levels of government amounted to 14.1 percent of GDP in the United States in 2001 as compared to 13.4 percent for the average OECD country (see Exhibit 4).

The Federal Government is even more heavily reliant on income and profits taxes as there is no broad base consumption tax, like the retail sales tax used in 45 states and the District of Columbia. Indeed, the United States is the only OECD member country that does not have a national value-added or goods and services tax.

From a trade perspective, heavy reliance on income taxes relative to consumption taxes may be viewed as disadvantageous because World Trade Organization (WTO) rules only permit border tax adjustments (i.e., exemption of exports and taxation of

imports) on indirect taxes. Absent border adjustments, taxes may distort the composition if not the volume of trade.<sup>2</sup> An important reason to avoid over-reliance on income and profits taxes is that they discourage savings and investment, and thus suppress long-run economic growth.

#### *D. Personal Income Tax*

The average OECD central government imposed a top personal income tax rate of 37.6 percent in 2003 (see Exhibit 5). In the United States, the top Federal tax rate on ordinary income is 35 percent, less than the OECD average. However, unlike most of the OECD countries, individuals in the United States typically are subject to income tax by both Federal and state levels of government.

Unless the sunset in the 2001 Act is removed, the top Federal individual income tax rate will increase to 39.6 percent in 2011. This would put the United States 2 percentage points above the current average for OECD countries.

High marginal income tax rates discourage savings and work effort—particularly of secondary workers—and encourage tax avoidance and evasion. Moreover, countries with high personal income taxes are unattractive places to locate facilities with high-paying jobs such as corporate headquarters and research facilities.

#### *E. Corporate Income tax*

Immediately following the Tax Reform Act of 1986, which lowered the U.S. corporate income tax rate from 46 to 34 percent, the U.S. rate was relatively attractive. This is no longer true today. The U.S. corporate income tax rate increased to 35 percent in 1991, while the average OECD country's corporate rate fell to 29.3 percent in 2003—5.7 percentage points less than the U.S. rate. The average corporate rate for the 25 members of the newly expanded European Union is just 26.3, 8.4 percentage points less than the U.S. rate (see Exhibit 6). The United States is tied with Spain and Greece for third highest corporate income tax rate among the 30 OECD countries. Unlike most OECD countries, the United States imposes corporate income taxes at the state and, in some cases, local levels of government. Taking into account multi-level corporate income taxes, the disparity between the U.S. rate and the OECD average is likely greater.

Despite relatively high rates, the U.S. corporate income tax raises relatively little revenue. In 2001, U.S. corporate income tax receipts amounted to just 1.9 percent of GDP compared to the OECD average of 3.5 percent of GDP). U.S. corporate income tax receipts were suppressed in 2001 by the recession, the fall in the stock market, the terrorist attack of September 11, and the temporary adoption of bonus depreciation and extended loss carrybacks.

High corporate income tax rates are economically unattractive for a number of reasons. First, high corporate income tax rates make the United States a relatively unattractive location for corporate investment. In a global economy, countries with high corporate income tax rates may suffer a declining share of worldwide investment and reduced employment opportunities for local workers. Second, high corporate income tax rates encourage the shifting of income abroad. Within the limits of existing rules, companies have an incentive to establish inter-company prices and corporate financial structures that locate income away from high-tax jurisdictions. Third, the incentive to engage in tax planning increases the higher the tax rate, which reduces the corporate revenue yield and diverts valuable resources away from more economically productive activities.

#### DOUBLE TAXATION OF CORPORATE INCOME

In a tax system where corporate income is taxed a second time when paid as dividends to shareholders, high corporate income tax rates discourage businesses from operating in regular corporate form. While the 2003 Act reduced the shareholder level tax on corporate dividends, this relief is scheduled to sunset after 2008. If dividend relief is allowed to sunset, the United States would join Switzerland as the only OECD countries without double taxation relief and the top rate of income tax on dividends—combining Federal and individual level taxation—would increase from 44.75 percent today to over 60 percent after 2010 (see Exhibits 7 and 8).

#### *F. Payroll Taxes*

Payroll taxes provide the primary source of funding for the Social Security, Medicare, and Federal and state unemployment insurance systems. Social insurance and payroll taxes represent about one-fourth of government revenues in the United States, similar to the average for all OECD countries. While the expenditures from social insurance programs are progressive, the payroll tax is regressive. However, the regressivity of the Federal payroll tax is mitigated by the earned income tax credit, which is a refundable income tax credit targeted at low-income workers. In

addition, the portion of the Federal payroll tax dedicated to hospital insurance (imposed at 1.45 percent rate on employees and employers) is not subject to the wage cap that applies to the balance of Social Security taxes (imposed at a 6.2 percent on employers and employees).

#### FUTURE REVENUES AND OUTLAYS OF THE SOCIAL INSURANCE SYSTEM

Like many other advanced industrial economies, the projected increase in the obligations of the U.S. social insurance system are far greater than the revenue stream that will be generated by existing funding sources. In 2003, the General Accounting Office estimated that future liabilities for the Social Security and Medicare systems would exceed future revenues for these program by \$20.7 trillion in present value, not including the new Medicare prescription drug benefit enacted earlier this year (see Exhibit 9).<sup>3</sup> This unfunded liability amounts to over \$71,000 for every U.S. citizen.

#### *G. Consumption and Excise Taxes*

The United States is one of the few countries that does not have a national level value-added or goods and services tax. The main form of consumption tax is the retail sales tax which is imposed by 45 states and the District of Columbia as well as approximately 7400 local jurisdictions. The retail sales tax system has a number of disadvantages as compared to the VAT. In particular, the retail sales tax excludes most services and, unlike the VAT, cannot be fully recovered by business purchasers, with the result that the tax can cascade through the production/distribution chain.

#### IV. TAXATION OF INCOME FROM U.S. DIRECT INVESTMENT ABROAD

##### *A. Do the Foreign Operations of U.S. MNCs Hurt the Domestic Economy?*

If taxes make the United States an unattractive location to headquarter a multinational corporation, then U.S. multinationals will lose global market share. This loss in global market share can happen in a variety of ways. First, U.S. individual and institutional investors can choose to invest in foreign rather than U.S. headquartered companies. Second, in a cross-border merger, the transaction may be structured as a foreign acquisition of a U.S. company rather than the reverse. By choosing to be headquartered abroad, the merged entity can invest outside the United States without being subject to the complex and onerous U.S. rules that apply to the foreign source income of U.S.-headquartered companies.<sup>4</sup> Third, and most starkly, a number of U.S. companies have structured transactions in which their U.S. parents are acquired by their own foreign subsidiaries. Such "inversion" transactions, like foreign acquisitions of U.S. companies, allow new foreign investments to be structured as subsidiaries of a foreign parent corporation and thus not subject to U.S. rules relating to the taxation of foreign source income. Fourth, new ventures can be incorporated at inception as foreign corporations.

A decline in the market share of U.S. multinationals would adversely affect domestic workers. U.S. multinationals play an important role in promoting U.S. exports and creating high-wage jobs. According to the U.S. Commerce Department, in 2001, U.S. multinationals were directly responsible, through their domestic and foreign affiliates, for \$425 billion of U.S. merchandise exports-almost 60 percent of all merchandise exports. The role of multinationals in promoting exports is corroborated by an OECD study which found that each dollar of outward foreign direct investment is associated with \$2.00 of additional exports.<sup>5</sup> Dartmouth professor Mathew Slaughter has found that over the 10-year period 1991–2001, jobs added by U.S. multinationals abroad were matched almost two for one by U.S. jobs added in their parent operations.<sup>6</sup> Moreover, Slaughter finds that U.S. multinationals increased their domestic employment at a faster pace than U.S. companies without foreign affiliates-evidence that the foreign operations of U.S. multinationals increase domestic job growth. As noted by David Riker and Lael Brainard:

"Specialization in complementary stages of production implies that affiliate employees in industrialized countries need not fear the multinationals' search for ever-cheaper assembly sites; rather, they benefit from an increase in employment in developing country affiliates."<sup>7</sup>

U.S.-based multinationals account for 20 percent of domestic employment, and locate 77 percent of their global production and 80 percent of the global capital spending at home.<sup>8</sup> In addition, multinational companies pay their domestic workers more than comparable U.S. companies without international operations.<sup>9</sup>

*B. Comparison of U.S. and Foreign Country Rules for Taxing Multinational Income*

Compared to major competitor countries, the United States is a relatively unattractive jurisdiction in which to locate the headquarters of a multinational company. Quantitative evidence of this comes from a study published by the European Commission in 2001 which found that, on average, U.S. multinationals bear a higher effective tax rate—ranging from three to 5 percentage points—when investing into the European Union than do multinationals headquartered in the EU (see Exhibit 10).

Aside from the relatively high U.S. corporate income tax rate, there are a number of features of the U.S. system of taxing foreign source income that depart from international norms.

Worldwide tax system. Over half of the OECD countries have dividend exemption (“territorial”) tax systems under which a parent company generally is not subject to tax on the active income earned by a foreign subsidiary (see Exhibit 11). By contrast, the United States generally taxes income earned through a foreign corporation when repatriated.<sup>10</sup> Moreover, the United States is the only OECD country that does not exempt the foreign earned income of its citizens who reside abroad, making it more expensive for U.S. multinationals to send employees on international assignments.<sup>11</sup>

Foreign tax credit limitations. The U.S. foreign tax credit, which is intended to prevent double taxation of foreign source income, has a number of deficiencies that increase complexity and prevent full double tax relief, including:<sup>12</sup>

- Over allocation of U.S. interest expense against foreign source income due to failure to take into account foreign debt. This reduces the foreign tax credit limitation and can cause income that has been subject to foreign tax at a rate of 35 percent or more to be subject to additional U.S. tax;
- Asymmetric loss recapture rules that have the effect of restoring U.S. but not foreign income, thereby reducing the foreign tax credit limitation;
- The limitation on foreign tax credits to 90 percent of alternative minimum tax liability;
- The limited carryover period for foreign tax credits (two years back and 5 years forward); and
- The complexity associated with the numerous separate foreign tax credit limitations and the “high-tax kick out” rules that move certain income out of the passive basket.

U.S. anti-deferral rules. Another difference from the multinational tax rules of other countries is the unusually broad scope the U.S. anti-deferral rules under sub-part F. While most countries tax passive income earned by controlled foreign subsidiaries, the United States is unusual in taxing a wide range of unrepatriated active income as a deemed dividend to the U.S. parent, including:<sup>13</sup>

- Foreign base company sales income;
- Foreign base company services income;
- Foreign base company shipping income; and
- Active financial services income (a temporary exclusion of this income from Sub-part F will expire for taxable years beginning after 2006).

Moreover, the U.S. anti-deferral system is extraordinarily complex, with multiple and overlapping rules including separate regimes for: controlled foreign corporations (CFCs), passive foreign investment companies (PFICs), foreign personal holding companies (FPHCs), foreign investment companies (FICs), and Personal Holding Companies (PHCs).<sup>14</sup>

The net effect of these differences between U.S. tax rules and international norms, is that U.S. multinationals frequently pay a greater share of income in foreign and U.S. tax than do competing multinationals headquartered outside of the United States.

*C. Recent Legislative Proposals*

The ETI replacement bills adopted earlier this year by the House and Senate contain international tax reform provisions that would address many of the aspects of U.S. tax law that depart from international norms in ways that adversely affect the competitiveness of U.S. multinationals.

Foreign tax credit. Both bills alleviate the double taxation of foreign source income through measures addressing interest allocation, recharacterization of domestic losses, and removing the 90-percent limitation in the AMT. The House bill also reduces the number of separate foreign tax credit limitation categories, while the Senate bill extends the carryforward period for foreign tax credits to 20 years, consistent with net operating losses.

Anti-deferral rules. Both bills reduce the taxation of active foreign income that is reinvested abroad by “looking through” payments between related CFCs to determine their character and by excluding certain active foreign shipping and aircraft

income from Subpart F. Both bills also simplify compliance with Subpart F by repealing the FPHC and FIC rules and the PHC rules applicable to foreign corporations. In addition, the Senate bill simplifies compliance by increasing the de minimis exemption from Subpart F.

#### V. COMPLEXITY

The burden of the tax system includes not only the amount that taxpayers are obliged to remit to the government but also the time and money cost of compliance, including researching and monitoring changes in tax laws and regulations, collecting information required for return preparation, preparing and filing the return, record retention, and responding to audits. Compliance costs were estimated by the Tax Foundation to increase the burden of the Federal income tax by 20.4 percent, or \$194 billion in 2002.<sup>15</sup> By comparison, estimates of the compliance costs imposed by the retail sale taxes typically are on the order of 3–4 percent of revenues.<sup>16</sup>

Some of the complexity of the income tax system is inherent in measuring taxable income in a technologically advanced and globally integrated economy. There are few remedies for this inherent complexity short of adopting an alternative basis of taxation, such as consumption.

#### PROLIFERATION OF SPECIAL PURPOSE DEDUCTIONS, CREDITS, AND EXEMPTIONS

One important source of complexity is a policy choice—the use of special purpose deductions, credits, and exemptions in the Code to encourage certain types of economic activities or to redistribute income to specific groups of taxpayers judged needy of assistance. Many of the policy objectives underlying these special purpose deductions, credits and exemptions could be achieved through Federal spending programs, subject to the Congressional authorization and appropriations process, and administered by Federal agencies other than the IRS.

#### ALTERNATIVE MINIMUM TAX

Redesigned in 1986, the alternative minimum tax (AMT) for individuals and corporations operates like a parallel tax system. Taxpayers compute tax liability twice: under the regular system and under the AMT system, with its own separate tax base and rates. AMT liability is equal to the excess, if any, of tax liability under the AMT system over the regular system. Certain AMT payments may be carried forward and used to offset regular tax in future years to the extent in excess of liability determined under the alternative system.

On its face, the AMT system is inherently complex as it requires calculation of tax liability under two different systems. It imposes compliance burdens on all taxpayers—whether or not AMT is owed—because, in principle, they must calculate hypothetical liability under the alternative system to determine whether AMT is due and whether the use of tax credits under the regular tax system is constrained by the AMT.

Worse still, for individuals, the AMT is becoming far more pervasive because (1) the dollar amount of the AMT exemption was not indexed in 1986, and (2) the regular tax rates but not the AMT rates were reduced in 2001 and 2003. As a result, CBO estimates that the number of returns affected by the AMT will increase from 3 million in 2004 to 29 million in 2010.<sup>17</sup>

Fixing the AMT is a serious budgetary challenge. The Congressional Budget Office has estimated that indexing the AMT exemption amount at 2004 levels would cost \$376 billion over the next 10 years.<sup>18</sup>

#### TAX CODE INSTABILITY

Another source of compliance burden is the frequency of changes in the tax Code. According to the Tax Foundation, from 1995 to 2000, the tax Code increased by 182 pages, about half the pages of the entire 1954 Code. At this rate, the Code will increase from 1670 pages in 2000 to about 2600 pages in 2010.

Tax Code instability also is due to the adoption of tax provisions on a temporary basis to comply with budgetary scoring rules. These sunsets create uncertainty and impose real costs on taxpayers. The most absurd example is the scheduled repeal of the estate and gift tax in 2010 and re-enactment in 2011. This is an example of how rules designed to promote fiscal responsibility have had the side effect of creating tax structure instability.

#### FOREIGN SOURCE INCOME

As noted in the administration's fiscal year 2003 budget, one of most complex aspects of corporate taxation is the treatment of foreign source income. A survey of

Fortune 500 companies found that 43.7 percent of U.S. income tax compliance costs were attributable to foreign source income even though foreign operations represented only 26–30 percent of worldwide employment, assets and sales.<sup>19</sup> These high compliance costs are a hidden form of taxation that discourages small U.S. companies from operating abroad and makes it more difficult for larger companies to compete successfully with foreign multinationals.

#### VI. SUMMARY

This testimony supports the following conclusions:

- U.S. residents currently pay a smaller share of GDP in total taxes than do residents of most other OECD countries.
- However, the present U.S. tax structure does not generate sufficient revenue to meet projected Federal spending in the long run.
- Closing the fiscal gap by raising income and profit taxes would cause the U.S. tax system to depart even further from international norms, as the United States already relies much more heavily on income and profit taxes—both as a percent of GDP and as a percent of total taxes—than the average OECD country.
- The U.S. corporate income tax rate is tied with Greece and Spain as third highest among the OECD countries.
- If the 2001 and 2003 Act sunsets are not reversed, the top central government individual income tax rate in the United States will by 2011 jump to 2 percentage points above the current average for OECD countries.
- According to the Tax Foundation, the cost of complying with the Federal income tax system increases the U.S. tax burden by 20 percent. This is much higher than estimates of the cost of complying with VAT and retail sales tax systems.
- A particularly worrying source of tax complexity is the estimated increase in the number of individual returns affected by the AMT from 3 million in 2004 to 29 million in 2010.
- The U.S. international tax rules are out of step with competitor countries. The U.S. system of taxing worldwide income is extremely complex and imposes high compliance costs relative to revenue raised.

#### ENDNOTES

<sup>1</sup>OECD, *OECD in Figures: Statistics on the Member Countries*, 2003.

<sup>2</sup>A theoretical framework is set forth in, Martin Feldstein and Paul Krugman, “International Trade Effects of Value Added Taxation” (with Paul Krugman) in *Taxation in the Global Economy*, Assaf Razin and Joel B. Slemrod, (eds.), the University of Chicago Press, 1990. Consistent with the standard theoretical model, empirical research finds there is no export or trade advantage for countries with greater reliance on value-added taxes. In fact, Hines and Desai find a negative relationship which the authors attribute to two implementation features of VAT systems: VATs tend to be imposed at higher rates on traded than non-traded goods and exporters often receive incomplete VAT rebates See, James R. Hines, Jr. and Mihir A. Desai, “Value Added Taxes and International Trade: The Evidence,” (November 2002) presented at December 2002 Brookings/ITPF conference on Tax Systems and International Trade ([www.itpf.org/presearch—itpinindex.htm](http://www.itpf.org/presearch—itpinindex.htm)).

<sup>3</sup>U.S. General Accounting Office, *Financial Statement of the United States Government*, 2003.

<sup>4</sup>Note that, absent restructuring, the existing foreign operations of a U.S. company acquired by a foreign company remain subject to U.S. tax rules.

<sup>5</sup>OECD, *Open Markets Matter: The Benefits of Trade and Investment Liberalization*, p. 50 (1998).

<sup>6</sup>Mathew J. Slaughter, “Globalization and Employment by U.S. Multinationals: A Framework and Facts,” *Daily Tax Report*, March 26, 2004, section J, pp. 1–7.

<sup>7</sup>David Riker and Lael Brainard, U.S. Multinationals and Competition from Low Wage Countries, National Bureau of Economic Research Working Paper no. 5959 (1997) p. 19.

<sup>8</sup>Laura D’Andrea Tyson, “Why The Trade Deficit May Not Loom So Large,” *Business Week*, June 7, 2004

<sup>9</sup>Doms and Jensen find that U.S. plants of companies without foreign operations pay production workers 10–15 percent less and nonproduction workers 5–7 percent less than comparable plants of U.S. multinational companies, controlling for industry, size of company, and state where the plant is located. See, Mark Doms and Bradford Jensen, *Comparing Wages, Skills, and Productivity between Domestic and Foreign-Owned Manufacturing Establishments in the United States*, mimeo. (October 1996).

<sup>10</sup>I am unaware of any OECD country that requires formula apportionment of domestic interest expense to exempt foreign dividends with the result that this portion of domestic interest expense is nondeductible. Grubert and Mutti find that adoption of a dividend exemption system with formula apportionment of domestic interest expense would actually increase the U.S. tax burden attributable to foreign source income. See, H. Grubert and J. Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System*, American Enterprise Institute, 2001.

<sup>11</sup>See, Price Waterhouse, "Economic Analysis of the Foreign Earned Income Exclusion," 1995.

<sup>12</sup>See, National Foreign Trade Council, U.S. International Tax Policy for the 21st Century, vol. 1, Part II, 2001

<sup>13</sup>Ibid., vol. 1, Part I.

<sup>14</sup>See, Carl A. Dubert and Peter R. Merrill, *Taxation of U.S. Corporations Doing Business Abroad: U.S. Rules and Competitiveness Issues* (Second Edition), FEI Research Foundation, 2001.

<sup>15</sup>Scott Moody, "The Cost of Tax Compliance," Tax Foundation, February 2002. Using a different methodology, Prof. Joel Slemrod estimated the private sector collection cost of the U.S. income tax system at \$125 billion in 2004. See, Joel Slemrod, "Written Testimony submitted to the Committee on Ways and Means, Subcommittee on Oversight, Hearing on Tax Simplification," June 15, 2004.

<sup>16</sup>Tax Administrator News, 1993.

<sup>17</sup>CBO, The Budget and Economic Outlook, Fiscal Years 2005 to 2014, January 2004, p. 81.

<sup>18</sup>Ibid. pp. 5-7.

<sup>19</sup>Marsha Blumenthal and Joel Slemrod, "The Compliance Costs of Taxing Foreign-Source Income: Its Magnitude, Determinants, and Policy Implications, International Tax and Public Finance, vol. 2, no. 1, 37-54 (1995).

Chairman NUSSLE. Dr. Gale, welcome back to the committee. We are pleased to receive your testimony. As I said, your full written testimony will be made part of the record, and you may summarize.

#### STATEMENT OF WILLIAM G. GALE

Mr. GALE. Thank you, Mr. Chairman and members of the committee, for inviting me to testify. It is always an honor to appear here. I want to start by highlighting the fact that on behalf of policy wonks and budget analysts everywhere, I applaud the committee's efforts to focus on the important role of uncertainty in shaping budget outcomes and policies.

My testimony will be both capped and verifiable.

Chairman NUSSLE. Just pay-as-you-go, too, will you?

Mr. GALE. I would like to address four topics. The first is, how good are the growth assumptions and baseline projections made by the CBO.

I think it is fair to say that CBO does a very good job of forecasting future economic activity and its relation to revenues and spending. It is a fact that the projections are often wrong, sometimes by sizable amounts. It is also a fact that it is very hard to understand when the economy changes directions. But my understanding is that CBO does as well or better than anyone else who tries to define the economic future. So in this case, CBO is not the cause of the uncertainty; they are just the messenger.

Doug Holtz-Eakin gave you the choice of shooting or blaming the messenger. I would suggest we not even blame the messenger. My sense is that CBO is doing a very good job on this score.

The second question is, if it is not CBO, what is it that is causing the baseline budget projections to be so uncertain? And here I think the dominant form of uncertainty is uncertainty about the future of the economy. Future GDP is difficult to predict precisely,

and small differences in the future GDP turn into big differences in budget deficits.

So, for example, CBO in January predicted a real growth rate of 3 percent over the next decade. That is a perfectly reasonable estimate, but it is also an uncertain estimate. And if the growth rate is off by three-tenths of a percentage point, the difference in the budget deficit is about \$700 billion over the next decade. So relatively minor changes in the growth rate of GDP make big differences in the projected budget deficit.

Given the size of the economy, uncertainty about other economic factors is also important. In the 1990s, the shifting distribution of income, the enormous capital gains in the stock market and changes in inflation and interest rates had a significant effect on budget outcomes. Usually, however, these impacts are not as large. The late 1990s and the early part of this decade were unusual in that respect.

The third factor is the actual structure of tax policy. I don't have access to the detailed models that CBO does, but my sense is, given the size of the economy, given the structure—in terms of interest rates, inflation rates, the level of the stock market—the actual structure of tax policy doesn't contribute that much additional uncertainty to the budget forecast.

For example, it would be wonderful if we taxed different activities at the same rate and we reduced the disparity across activities in the indifferent taxation. But even if we did, we would still face enormous amounts of budget uncertainty; that would not solve the problem. So I think we are stuck with uncertainty and have to deal with it.

The second issue dealt with uncertainty in the baseline. A third issue is, even if we got the baseline right, the baseline is becoming an increasingly useless measure of realistic actual budget outcomes. That is, even if you know exactly what the baseline is, you still have no idea these days what a realistic policy is going to turn out to be. And this relates to concerns that both of the other witnesses mentioned.

I want to highlight three issues in particular. One is the enormous increase in the use of expiring tax provisions and sunsets in the Tax Code. So we know how the baseline treats them. What we don't know is what is a good, realistic way to think about them.

The second issue is the existence of specific unsustainable policies. And here the AMT is a perfect example. Nobody believes that we are going to end up with 30 million people on the AMT by 2010 and almost 40 million people by 2014, but that is what is built into the budget forecast. And so it increases uncertainty between the baseline and what the actual budget outcome will be.

The third issue, which is even harder to address, is the existence of an overall unsustainable fiscal policy; that is, everyone who looks at the current trajectory of spending and taxes says, This can't go on. But that is what the baseline has in the current-law trajectory.

So all three of those factors mean that even if we got the baseline exactly right, the baseline is increasingly becoming less useful as a measure of budget outcomes.

The last issue is, what do we do about uncertainty? There are really two issues here: How do we reduce it and how do we deal with whatever uncertainty is left?

Reducing uncertainty is pretty straightforward—in theory, at least. It is easy for me to say and tell you how to reduce it, but it will involve some pretty difficult choices. The way to reduce it is to undo the features of the Tax Code that create uncertainty, so, for example, a budget-conscious fix to the AMT problem, some fix to the unsustainability of fiscal policy generally, and in particular, these issues will all come to a head in thinking about whether to make the tax cuts permanent.

At first glance, you might think that making the tax cuts permanent would reduce uncertainty because it tells people that there is a commitment to lower tax rates for the long term. But, remember, one of the issues that generates uncertainty is the existence of an unsustainable fiscal policy. And if you cut taxes you make the fiscal gap, the unsustainability of fiscal policy, even worse.

And so that not only raises uncertainty about how and when the fiscal gap will be closed, but at some point it can raise uncertainty about whether the fiscal gap will ever be closed. And at that point it is not an issue of the economy creating uncertainty in the budget; it is an issue of the budget creating uncertainty in the economy. That is a completely gratuitous uncertainty that is particularly damaging to the economy.

Besides fixing the specific policies that lead to uncertainty in the Tax Code, there are a number of other things policy-makers could do to reduce the impact of uncertainty. One is simply to give realistic budget projections more weight in the policy process than they currently have relative to the baseline.

In 2001, for example, it was mentioned we had a baseline surplus of \$5.6 trillion; realistic budget surpluses puts it between \$1 trillion and \$1.7 trillion over the decade, which obviously is quite different from 5.6 trillion.

A second issue is to distinguish between projections that are more certain than those that are less certain. If you know how many 50-year-olds there are now, you can make a pretty good guess how many 70-year-olds there will be in 20 years. However, if you know the size of the economy now, you don't have a clue as to how much it is going to grow in the next 20 years. So certain things like demographics, at least over the medium term, are uncertain, but are relatively certain compared to things variation in economic growth.

So, for example, the long-term fiscal crisis that the Nation faces is subject to an enormous amount of uncertainty, yet almost everyone that looks at the reasonable magnitudes of uncertainty decides that we still have a fiscal crisis even after adjusting for that.

The third issue I would suggest is to think about how families respond to uncertainty. Families face pervasive uncertainty about jobs, about future income, future spending needs, future health needs; and typically they respond to that by trying to establish a reserve fund. That might be very difficult given the way the Federal budget is set up to literally establish a reserve fund, but one thing Congress could do is not allocate every available dollar to tax cuts and spending increases and try to establish and hold on to a

budget surplus on an ongoing basis. That would also help with the national saving issue that Pam Olson mentioned.

My last point is just that I want to end where I started, which I think it is very important that the Budget Committee does consider uncertainty. And I applaud your efforts in that regard. There is a danger though. Because of uncertainty things could end up a lot better than they are, they could end up a lot worse than they are.

The danger is that people use uncertainty as a method of procrastinating or avoiding dealing with the serious issues. I think it is fair to say that almost everyone who has looked at the fiscal situation facing the country thinks that we can't just grow out of it, it won't just go away on its own. But as soon as one invokes uncertainty there is the conceptual possibility that it could.

So let me just close by saying, focusing on uncertainty is very important, but it would be unfortunate if that appropriate focus led to the inappropriate willingness to procrastinate and avoid facing the real fiscal problems.

Thank you.

[The prepared statement of Mr. Gale follows:]

PREPARED STATEMENT OF WILLIAM G. GALE, SENIOR FELLOW, THE BROOKINGS INSTITUTION, TAX POLICY CENTER

*Arjay and Frances Fearing Miller Chair, Economic Studies Program, and Co-Director, Tax Policy Center. The views presented are my own and should not be taken to represent the views of the Brookings Institution or the Tax Policy Center.*

Chairman Nussle, Ranking Member Spratt, and members of the committee: Thank you for inviting me to testify today. It is always an honor to appear before this committee. I applaud the committee's efforts to focus on the important role of uncertainty in shaping budget outcomes and policies. I'd like to address four questions.

The first question is how good are the growth assumptions and baseline projections made by the Congressional Budget Office? I think it is fair to say that the CBO does a very good job of forecasting future economic activity and its relation to revenues and spending. The CBO's projections are often wrong, sometimes by sizable amounts. It is particularly difficult to predict and understand turning points. But my impression is that CBO does as well as, or better than, anyone else who tries to divine the economic future.

The second question is what causes the baseline projections to be so uncertain? The primary source of uncertainty in the baseline projection is uncertainty regarding the overall size of the economy in the future. Not only is future GDP difficult to predict precisely, but small differences in assumed growth rates can generate large changes in budget outcomes.

For example, in January, CBO predicted a real growth rate averaging 3.0 percent per year over the next decade. This is a reasonable estimate, but everyone would agree there is substantial uncertainty surrounding the exact figure. If the annual rate of economic growth turns out to be just three-tenths of a percentage point larger or smaller than CBO projects, the difference in the deficit will be about \$700 billion over the next 10 years (CBO, Economic and Budget Outlook for Fiscal Years 2005–14, January 2004, Appendix B).

Compared to the size of the economy, uncertainty about other economic factors is usually significantly less important in generating budget projections. Such factors include the rate of inflation, the level of interest rates, and the level of the stock market. While it is true that changes in capital gains have significantly influenced revenues over the past several years, it has required enormous, atypical changes in capital gains to have that effect, and the effects have been far smaller than those due to changes in the size of the economy. Typical changes in inflation, interest rates, and the stock market generate modest changes in budget projections.

Given the size of the economy, and given the other economic factors—like capital gains, inflation, and interest rates—the actual structure of tax policy plays a very small role in generating uncertainty in the baseline projections. To be more specific, the current tax system taxes different people and different forms of income at dif-

ferent rates. Even if we taxed everyone at the same rate on all activities, the great majority of uncertainty would still be present in budget projections.

A third issue is that the baseline projection is becoming an increasingly misleading measure of realistic budget outcomes. This increases everyone's uncertainty regarding what the actual budget outcome will be, given the baseline. This trend is due to several factors, most notably: (i) the enormous increase in the use of expiring tax provisions and sunsets in the Tax Code; (ii) the presence of specific unsustainable policies, like the built-in growth of alternative minimum tax, which no one believes will be allowed to persist; and (iii) the presence of an overall unsustainable fiscal policy stance, such as we now face. When policy-makers enact laws that are fiscally unsustainable or that are designed in a blatant manner to skirt budget rules, the effect is to increase uncertainty about the course of future Federal policy. This likely has negative effects on the economy.

The fourth issue is what to do about uncertainty in the budget projections. There are two policy questions: how to reduce uncertainty and how to respond to whatever uncertainty is left in the system.

If the main source of uncertainty is the economy itself, then policy-makers will always face a significant amount of uncertainty. But policy-makers can still reduce uncertainty in several ways. The best way to reduce uncertainty is avoid creating fiscally unsustainable policies. A second way is to avoid creating artificial sunsets.

These issues will come to a head in dealing with whether to make the 2001 and 2003 tax cuts permanent. At first glance, one might think that making the tax cuts permanent would reduce uncertainty since it indicated a long-term Congressional commitment to lower tax rates. Making the tax cuts permanent, however, will substantially increase the severity of the fiscal gap between revenues and spending and hence it will serve to increase uncertainty about how and when the overall fiscal gap will be closed. In fact, making the tax cuts permanent in light of the current fiscal situation is sufficiently irresponsible that it may lead to investors wondering not just how and when the fiscal gap will be closed, but whether it will ever be closed. That is, several knowledgeable observers, most notably Treasury Secretary Robert Rubin, have raised the concerns that ever-increasing Federal debt projected for the medium- and long-term could seriously disrupt financial markets and the broader economy.

In contrast to extending the tax cuts, letting them expire would reduce uncertainty about the tax system as well as reduce uncertainty about the overall fiscal gap. Likewise, establishing a budget-conscious solution to the AMT problem would go a long way toward reducing uncertainty about future tax rates and reduce uncertainty regarding whether, how, and when the fiscal gap will be closed.

Policy-makers should also shape policies explicitly in light of the fact that uncertainty is present. First, I think that realistic budget projections should be given more weight in the policy process than they currently are. The baseline is useful for understanding the effects of legislation, but is extremely misleading as a guide to what likely budget outcome are going to be. The reason why is that the baseline is constructed according to certain fixed rules for projecting spending and revenues that do not reflect likely or plausible outcomes. If policy-makers paid more attention to alternative, realistic forecasts of likely budget outcomes rather than the baseline, they would not be so surprised by many of the changes in the budget projections.

Second, policy makers should distinguish between projections that are more certain and those that are less uncertain. Population growth, for example, is relatively certain in the medium term. If you know how many 50 year olds are alive today, chances are you can make a pretty good guess at how many 70 year olds will be alive in 20 years. On the other hand, if you know the size of the economy today, that may provide very little guidance for estimating the change in the size of the economy over the next 20 years. Along similar lines, almost every study finds that the nation faces a substantial long-term fiscal shortfall, even though there is substantial uncertainty about many economic factors over the long-term. Simply put, population aging and health care technologies will create budgeting problems under almost any scenario.

Third, Congress should consider ways to adopt budget rules that not only limit both tax cuts and spending increases but also do so in a way that does not let every available dollar be allocated as soon as it appears. Families face substantial economic uncertainty about future wages, health, asset returns, and so on. They often manage that uncertainty by trying to keep a financial reserve. A literal financial reserve might be hard to establish at the Federal level, but budget rules that limited the extent to which policy-makers could create future tax cuts and spending increases would be a step in the right direction.

My last point is that perhaps the biggest danger in acknowledging the importance of uncertainty is that it will allow policy makers to shrug off any potential fiscal

problems with the insight that the problems might go away on their own. Current, plausible budget projections suggest significant medium-term deficits and very sizable long-term deficits. But the presence of uncertainty suggests that these problems could conceivably go away on their own. This observation might tempt politicians to delay seeking solutions, hoping to avoid the daunting economic and political risks associated with large-scale tax increases and spending cuts. Indeed, in the last few years, the majority of legislators have chosen not only to ignore the long-term fiscal problems but to make them substantially worse by enacting and advocating significant tax cuts and spending increases. But it is extremely unlikely that the current fiscal problem will resolve itself without policy actions, and delays in addressing the issue will only make the eventual solutions more extreme and painful. It would be a travesty if the explicit recognition of uncertainty in the policy process led policy-makers to choose to avoid dealing with the serious fiscal problems the country faces.

Chairman NUSSLE. Mr. Baird.

Mr. BAIRD. I thank the chairman for bringing together this outstanding group of panelists. I also in sincerity want to commend the chairman. As I heard some of the testimony, it would suggest to me that some of the ways we have gone about passing some of the tax cuts in the last couple of years have actually enhanced the complexity and the uncertainty in the Tax Code and thereby distorted the decision-making process and certainly the predictability process. The use of expiring tax cuts as a way to say that the deficit and fiscal implications will be smaller than they might actually be creates not only a false impression, but a difficult thing in predicting and some strange impacts in terms of budget deficits, et cetera.

One of the questions I would have, and I will direct this perhaps initially to Ms. Olson, it seems to me, to sort of an average commonsense kind of person, that most folks would say, look, people who make income by taking their lives and their time and working their guts out, it is reasonable to say that maybe they should face a different level of taxation or different kinds of taxation on that income than somebody who, let's say, was given a million and the million generates a lot of income for them while they go play in the surf or something.

Are you suggesting that we should treat the income from the million dollars given to someone as the same as the income for somebody who has to work every day of their life and leave their family and go risk their lives and time?

Ms. OLSON. Well, I guess I am not sure that I would use the Tax Code to try to achieve a social objective, if what we are trying to do is to say—essentially what we are doing is redistributing the tax burden on the basis of somebody being born with wealth versus somebody not being born with wealth and having to work for a living as I do. But—

Mr. BAIRD. And 99 percent of my constituents do.

Ms. OLSON. I think 99 percent of the people I know do as well. But one of the things that the Tax Code does—let's set aside somebody who was born with \$1 million and instead consider somebody who, because they have chosen not to spend everything they earned but—

Mr. BAIRD. I would agree with that distinction.

Ms. OLSON [continuing].—accumulated a nice nest egg. What happens under our tax system over time is that that person who is deferring spending, delaying gratification, which I think we would all say is a virtue, is going to end up carrying a larger share

of the tax burden in this country. I am not sure that is the right message for us to be sending people. It seems to me it is a bad civics lesson.

So then if you go back and you try to figure out how would you make it different, do you really want to have something that goes back and asks whether somebody was born with money or had to work to get it? That is a kind of intrusiveness on the part of the government that I find somewhat troublesome.

Mr. BAIRD. I think government by nature has to be somewhat intrusive. It is an illusion to believe we are not. The absence of policy is in fact an influence on behavior whether or not we like it.

Don't most Americans pay more in payroll taxes now than in income taxes? Isn't it somewhere around 80 percent pay more in payroll tax than income tax?

Mr. GALE. That is basically right. Some of those numbers, it depends on whether you attribute the employer portion to worker or not. But most studies suggest that the employer portion is borne by workers in lower after-tax wages, so it is reasonable to do that.

Mr. MERRILL. I believe about 30 percent of households do not pay income tax on that basis.

Mr. BAIRD. So for a significant number of people, we have a de facto hybrid system and a flat tax. In a sense, you have a flat tax on the base level of your wages and an income tax on something on top of that. If you live in a State with sales tax, you have a sales tax in addition to that. Is that more or less accurate?

Mr. GALE. It is more or less accurate. It is very difficult to characterize the existing system in simple terms because the system itself is so complicated. There is some question as to whether it is appropriate to call what we have an income tax because so many forms of saving are actually exempted.

Mr. BAIRD. It would seem that one of the questions we would face in this body—we could sit around and maybe in a few weeks or months come up with a better system, and then some—there would be a little tap on the door by a lobbyist who would say, but you know, we could make it better.

Chairman NUSSLE. Little tap on the door?

Mr. BAIRD. There would be 4,000 of them tapping, Mr. Chairman. And it sort of becomes whose—the one point that I would close with is, you would be insane, literally, to defend the current Tax Code, not only just as a politician but just as a normal rational human being, say that is really the best way to do things, the best of all possible worlds. And yet we seem unable to resolve it. We use it on both sides, frankly, for partisan—we will attack you, you attack us, and somewhere that tapping of the lobbyist may have something to say about why we don't change that in more constructive ways. I thank the Chair very much.

Chairman NUSSLE. We have a series of votes. What I would like to do is have Mr. Cooper—I will make a couple comments or questions, then we will dismiss the panel. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

If I were to propose to my colleagues that someone give me an unlimited number of blank checks that I would hand out pretty much as I would like, I would pretty much be laughed out of this body. But when I read in Ms. Olson's testimony that tax expendi-

tures are uncapped, unverified, and unverifiable, that sounds like an unlimited number of blank checks. So suddenly an aura of respectability is given to an otherwise ridiculous program just because it goes through the Ways and Means Committee and is a tax break. Those sorts of ridiculous programs get covered with the speech material that we heard some of our colleagues mention a little earlier.

And when my colleague from Washington mentions the 4,000 knocks on the door that we get from various tax loophole lobbyists, they are essentially, every one of them, asking us for an uncapped, unverified, and unverifiable bunch of blank checks.

So, Mr. Chairman, I know that you serve on the Ways and Means Committee, it sounds like we might need to curtail the jurisdiction.

Chairman NUSSLE. Oh, I would be happy if you want to do a little bet here. I will bet you there are a lot more Members of this Congress that sign on to those as cosponsors than just the Ways and Means Committee members. I bet I could check your record on that, too. I wouldn't just blame the appropriators or the Ways and Means Committee.

Mr. COOPER. I am not saying blame anyone here. I think we need to try to cure it for all Americans. Before we can get to the important issues, Mr. Merrill and Mr. Gale, issues, macro issues and international issues, we have to solve the problem of how these tax breaks get inserted into the Code every day, every week, every year. It is now so chock full of them, we need to worry about curtailing the process.

So I wanted to ask any of the witnesses if you know, you gave us a great figure, Mr. Merrill did, perhaps about 20 percent of the cost of the Tax Code trying to figure it out or implement it, the taxpayer nightmare that we all face. Is there any good data on how much is spent on K Street and other parts of Washington, DC, trying to lobby Congress for these uncapped, unverified, and unverifiable tax breaks?

Because if you just think of it as an economic proposition, it must be so worthwhile for various interests around the country to pay folks to hang out in Gucci Gulch to get these uncapped, unverified, and unverifiable benefits, that it is essentially a good investment on their part to try to lobby us to get these unlimited number of blank checks.

But who is keeping data on, for example, how much money Skadden Arps makes or Merrill Lynch or PriceWaterhouseCoopers or all the other firms that are involved in this activity? How are we getting a handle on that expenditure and the results that are procured from these lobbying expenditures? Does anybody have any data on that?

Ms. OLSON. I don't have any data on that, but my guess is you capture a lot of it in the lobbying reports that are required to be filed.

Mr. COOPER. We know how much they spend to try and influence us, but we don't know the benefits that are resulting for their clients.

Ms. OLSON. That is right. We don't. We can only make estimates of it. I only want to say one thing on the unverifiable. There was

a qualifier there, which was largely unverifiable. And to the extent that you are talking about the folks who have enough money to actually come and knock on your door regularly, those folks are all part of the IRS's continuous examination program. So they are not likely to be able to get away with something without it at least being verified. That doesn't mean that there is a cap on it, however.

Mr. GALE. There have been a series of papers in a journal called Tax Notes the last year or so that goes through what different firms spend on lobbying, and tries to link that recent legislation. The author of the articles is named Marty Sullivan. I could track those down if you are interested.

I also want to mention a couple of things. If you talk to analysts who are not on the lobbyists' payroll, you will find nearly universal consensus among economists that broadening the base and cleaning out the loopholes is a good idea. And I put that on the table.

Second, the way these programs work, uncapped, unverified et cetera, it is essentially the way entitlement spending works. You set up the rules and then if you are eligible you qualify. The difference is that entitlement spending is for broad-based, wide swaths of the population. It is consistent with consensus, domestic policy goals, and it is out in the open; it is a spending program, whereas these subsidies are hidden deep, deep in the recesses of the Tax Code.

Mr. COOPER. I would agree. Entitlement programs are uncapped, but there is usually a verifiable measure such as, for example, turning age 65 that enables you to be a beneficiary. So these are verified and verifiable programs.

Chairman NUSSLE. Ms. Olson, what would you say is the largest tax provision that is unverified, largely unverifiable?

Ms. OLSON. Well, a lot of the—there are a lot of provisions on the individual side that are largely unverifiable. For example, the earned income tax credit. And there are a lot of difficulties with the earned income tax credit that make it an ineffective program, like, for example that it cannot function on an advance basis. If you really want to increase somebody's income on a constant basis, which would be our goal with the credit, generally speaking, we cannot do it. The reason is most taxpayers do not opt to claim the advanced earned income tax credit because they are concerned that their income is going to go too high and they will end up having to repay it at the end of the year, so they prefer to wait and make the claim on their tax return.

Were you to ask for the same kind of a benefit from the government through some other program, you would have walked into an office in advance and had your eligibility for it verified before you would actually get the check. That is not the way the earned income tax credit functions. It is an outlay on the basis of what you reported on your return. It is only if the IRS has some reason to suspect the accuracy of the return that they actually will freeze the money, not pay it out, and do a verification beforehand. But doing that has been very controversial.

So that is one example. There are a number of provisions affecting business taxpayers as well, probably not of that magnitude, but where it is very difficult for the IRS because it doesn't get third-

party records or some other way of verifying the item in the filing of the return.

Chairman NUSSLE. We have only 4 minutes left. Part of the reason why I wanted to have the opportunity of this hearing is to have you walk us through for members part of the reason why it take 3 years for information to get to us in a verifiable form and a final form. I don't know if it is possible for you to do that for the record, just to kind of give us an idea of how that might work. I don't think we have time to do it right now on the record because we have a vote with 3 minutes left. But I know I would be interested in that as well as any recommendations you would have for myself, Mr. Baird, or other members who are interested, and possible legislative ideas in order to do that. Because I understand some of the great ideas you were talking about, about how Congress complicates the Code. It is kind of like the gentleman was just saying: Don't be shocked, there are politics in Washington, there is lobbying in Washington, just like there is gambling in Vegas. I don't think we are going to get rid of that anytime soon.

Are there things we can do in the process of projecting that can help in this regard? And my understanding is that there may be. And I guess, finally, I would just observe that I don't believe I have ever had a tap on my door from a lobbyist with regard to EITC. Probably a few other ones have tapped for other reasons, but for the largest one I don't think I ever had that tap. So I think there are probably a lot of areas that we can work on here. So those would be the requests I would have.

I appreciate the three panelists for participating in today's hearing as well as from members who asked, I think, some great questions regarding how we can get our arms around this. And if there is nothing more to come before the committee, we will stand adjourned.

[Whereupon, at 12:35 p.m., the committee was adjourned.]

